Politics

**Paul Ryan Dares Obama On Medicare**

p22

Opening Remarks

**PHDs FOR QADDAFI**

p4

More Taxes!

**Bloomberg Government Insider's Guide to Revamping the Tax Code**

Plus


| | |
|---|---|
| **Missing: The U.S. Male Worker** | p7 |
| Japan's Stimulus Debate | p37 |
| **Charlie Rose and Bob Diamond** | p43 |
| Megabus's Cheap Seats | p62 |
| **Royal Wedding Crap for Sale** | p82 |


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# Bloomberg Businessweek

# HOW TO PAY NO TAXES

**11 shelters, dodges, and rolls —all perfectly legal—used by America's wealthiest people** p45

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# Contents



**How we roll**
The wide world of weird things people bet on p75

## Opening Remarks 4

When Muammar Qaddafi's image got buffed up by Harvard professors working for a consultancy called Monitor Group, the firm received $3 million a year—but at what cost?

## Global Economics 7

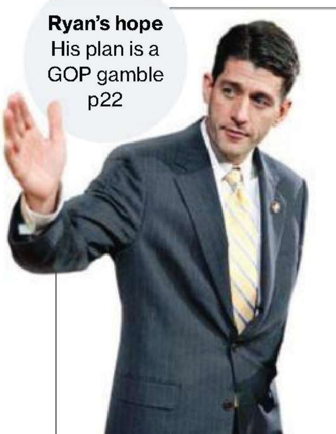
**Beyond a "mancession"**
Less than 65 percent of American men now have jobs. Why that's bad news for all of us

- Big Oil vs. Arab spring p8
- Thailand's smaller rice bowl p9
- Abu Dhabi's chip megadeal p10
- An ad crackdown in China p11
- Tom Keene's EconoChat p12
- Bold moves from Medvedev p12
- Seven days ahead p14

## Companies & Industries 16

**DVD Gangsters**
From Mexican drug cartels to the Russian mob, organized crime has piled into the movie-pirating biz

- U.S. suppliers are filling the post-quake Japan gap p18
- Estée Lauder is betting big on hair care with jungle roots p19
- Why 9,000 auto industry officials visit Arjeplog, Sweden, each winter p20
- Briefs p21



**Ryan's hope**
His plan is a GOP gamble p22

## Politics & Policy 22

**The audacity of Paul Ryan**
The scope of his budget blueprint is remarkable—even if its assumptions and prospects are unlikely

- Governors Jerry Brown and Andrew Cuomo are off to strikingly different starts p24
- A pro-big-bank bias in proposed federal regs p25
- The new layoff gender gap p26

## Technology 29

**The law firm techies "like"**
Why Silicon Valley's Fenwick & West is raking it in during the social-networking boom

- Taiwan's low-end PC makers are getting pummeled by the iPad p31
- Indie video game Minecraft has sold 1.75 million copies—with a marketing budget of zilch p32
- Innovator: Jennifer Pahlka puts coders into public service p34

## Markets & Finance 37

**Japan's money machine**
Finance Minister Shirakawa faces pressure to buy government bonds directly

- A foreign bank's $37 billion feast on Fed loans p38
- *American Idol*'s suitor p39
- The ongoing investor exodus at AllianceBernstein p40
- Why stocks may climb higher p41
- Bid & Ask: The week's deals p42
- Charlie Rose/Bob Diamond p42




**Bloomberg Government Insider** (Pull-out section)
Critics call the U.S. corporate tax code unfair and ungainly. Time for a redesign?

## Features 45

**Are You Still Paying Income Tax?**
Wealthy taxpayers have never had it better. A peek inside their (mostly) IRS-proof shelters p45

**Mad Dog's Magazines**
Richard Beckman left Condé Nast to stake his name on eight barely profitable trade publications p54

**The Megabus Effect**
How cheap intercity curbside buses are changing the way Americans get around p62

## Etc. 75

**Betting Big on the WNBA**
Hard-core professional gamblers are throwing down on women's basketball. And making a killing

- **The Office Lab** Are you a midday boozer? A table-hopper? A bread decliner? Here's what your power-lunch behavior is broadcasting about you p78
- **Television** Reality TV impresario Andy Cohen is now in front of the camera as well, where he's beating out Conan for viewers p80
- **Spinoffs** Wills-and-Kate wedding paraphernalia is officially out of control p82
- **One True Thing** Meet a sophisticated microbrew that sends the right message p85
- **The Stack** In *Money and Power*, William D. Cohan breaks down Goldman Sachs's profit-making methodology. It isn't pretty p86
- **Hard Choices** Adidas CEO Herbert Hainer on his ill-timed purchase of Reebok p88



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# Index





**A B**

- Acer 31
- Adidas 88
- Advanced Micro Devices (AMD) 10
- Agilent Technologies (A) B4
- AIG (AIG) 4, 40
- AllianceBernstein (AB) 40, 45
- Alcoa (AA) 14
- Amazon.com (AMZN) 42, B4
- Analog Devices (ADI) B4
- **Anschutz, Philip 47**
- Apache (APA) 18
- Apple (AAPL) 31, 32
- Archbridge Capital 8
- Argentis 20
- Asustek Computer 31
- Axa 40
- **Baker, James B20**
- Bank of America (BAC) 14, 43
- **Barber, Benjamin R. 4**
- Barclays (BCS) 43
- Barclays Capital (BCS) 8, 31, 40, 43
- **Baucus, Max B18**
- **Baweja, Bhanu 12**
- **Beckman, Richard 54**
- **Black, Conrad 54**
- Blackstone Group (BX) 78
- **Blankfein, Lloyd 86**
- Blockbuster 42
- Blueprint Sports Monitor 75
- BMW 20
- Boeing (BA) 21
- BoltBus 62
- **Bradley, Bill B20**
- Bravo 80
- Brewery Ommegang 82
- **Brown, Jerry 24**
- **Buffett, Warren 21, 46**

**C D**

- **Campbell, Gordon B14**
- **Camp, Dave B4**
- **Cantor, Eric B4**
- Carlyle Group 10
- Carnival (CCL) B4
- Caterpillar (CAT) 18
- CDR Financial Products 38
- Cerberus Capital Mgmt. 21
- **Chambers, John 31**
- Charles Schwab (SCHW) 14
- Chevron (CVX) B4
- **Christie, Chris 26**
- Cisco Systems (CSCO) 31
- Citibank (C) 54
- Citigroup (C) 40, B18
- CKX (CKXE) 39
- Clear Channel Communications 47
- **Clinton, Bill 78**
- **Cohen, Andy 80**
- Coldwell Banker Seal B16
- Condé Nast 54
- Continental B15
- **Cornyn, John B18**
- **Crapo, Mike B18**
- **Cuomo, Andrew 24**
- Danske Bank B15
- **Darman, Richard B20**
- **Davies, Howard 4**
- Dell (DELL) 31
- Deutsche Börse 42
- Dexia 38
- **Diamond, Bob 43**
- Diamond Foods (DMND) 42
- **DiMicco, Daniel B12**
- DirecTV (DTV) 54
- Discover Financial Services (DFS) 21
- Dish Network (DISH) 42
- Double Happiness 62
- **Doull, Matthew 54**
- Dow Chemical (DOW) 18
- Dunkin' Donuts 62
- **Dzurinda, Mikulá B15**

**E F G**

- Electronic Arts (ERTS) 21
- **Ellison, Lawrence J. 50**
- **Ensign, John B18**
- Ernst & Young 12
- Estée Lauder (EL) 19
- Euromonitor International 19
- ExxonMobil (XOM) 12, B4
- Fannie Mae (FNMA) 40, 43
- **Faust, Drew 4**
- Ferrari 11
- Fiat 20
- **Finkelstein, Jimmy 54**
- Ford Motor (F) 20
- Freddie Mac (FMCC) 43
- Freedom Group 21
- Fung Wah 62
- Gartner (IT) 31
- **Gates, Bill 21**
- **Gates, Bill Sr. B16**
- **Geithner, Timothy B4, B20**
- General Electric (GE) 39, 48, B2, B4
- General Motors (GM) 20, B18
- GlobalFoundries 10
- Goldman Sachs (GS) 43, 86, B4, B18
- Google (GOOG) 14, 21, 31
- **Gores, Alec 39**
- **Gorman, James 48**
- **Grassley, Chuck B18**
- **Green, George 54**
- **Greenstein, Robert B15**
- Greyhound 62
- Guggenheim Partners 54

**H I J**

- **Hainer, Herbert 88**
- Hallmark Fisheries 18
- **Handler, Richard B. 52**
- Harley-Davidson (HOG) B4
- Hearst Magazines International 54
- Hermès 11
- Hewlett-Packard (HPQ) 31
- HKI China Land 11
- Hollinger Capital 54
- Honda Motor (HMC) 14, 21
- **Hubbard, Glenn B13**
- Hyundai Motor 20
- **Icahn, Carl 42**
- IHS Automotive (IHS) 20
- Illyria 54
- **Immelt, Jeffrey 48**
- In-Stat 10
- Intel (INTC) 10, 31, B18
- IntercontinentalExchange (ICE) 42
- Island Def Jam Music 54
- ITA Software 21
- Jefferies Group 52
- J. Mendel 39
- Johnson & Johnson (JNJ) B18
- JPMorgan Chase (JPM) 14
- J.P. Morgan Securities 7

**K L M**

- **Kasich, John 26**
- **Kelly, Eamonn 4**
- **Kerry, John F. B18**
- **Khodorkovsky, Mikhail 12**
- Kia Motors B15
- Kinetic China 11
- King.com 32
- KKR (KKR) 42
- **Knight, Philip 48**
- **Kyl, Jon B18**
- Lamborghini 11
- Lancôme 54
- Legg Mason (LM) 40
- Leuthold Group 41
- **Lewis, Harry 4**
- Lineage Power Holdings 39
- LivingSocial 42
- Loews Hotels 78
- Los Angeles Dodgers 46
- Los Angeles Sparks 75
- Louis Vuitton 11
- **McCombs, Red 47**
- **McCourt Jr., Frank H. 46**
- McKinsey 11
- MEC Access China 11
- **Medvedev, Dmitry 12**
- Megabus 62
- **Menendez, Robert B18**
- Merck (MRK) B18
- MGM Mirage (MGM) 75
- Microchip Technology (MCHP) 18
- Microsoft (MSFT) 31, B16
- Minnesota Lynx 75
- Mintel International Group 19
- **Mishkin, Frederic 4**
- Möet 54
- Mojang 32
- Monitor 4
- Moody's (MCO) 26, B2
- Morgan Stanley (MS) 8, 12, 43, 48, B18
- Morgan Stanley MUFG Securities 37
- Moses & Singer 48
- Motorola Mobility (MMI) 31
- Mubadala Development 10
- **Murdoch, Lachlan 54**
- **Murdoch, Rupert 54**

**N O P**

- Nasdaq OMX (NDAQ) 42
- National Semiconductor (NSM) 42
- NBC 54
- NBCUniversal 80
- **Newhouse, Si 54**
- News Communications 54
- News Corp. (NWS) 54
- New York Liberty 75
- Nielsen 54
- Nike (NKE) 48, 88
- Nokia Siemens Networks 39
- Novel Commodities 9
- Nucor (NUE) B12
- **Nye, Joseph 4**
- NYSE Euronext (NYX) 42
- **Obama, Barack 45, B2, B4, B20**
- Occidental Petroleum (OXY) 10, 18
- Omega 11
- Oracle (ORCL) 50
- **Orbán, Viktor B15**
- **Packwood, Bob B20**
- **Page, Larry 14**
- **Pahlka, Jennifer 34**
- Paradigm 39
- Paramount Options 8
- **Paulson, Hank 86**
- **Persson, Markus 32**
- Peter Pan Bus Lines 62
- **Peterson, Pete 78**
- Peugeot 20
- Pfizer (PFE) 42, B4
- Platinum Equity 39
- Plum Creek Timber (PCL) B18
- Pluribus Capital Mgmt. 54
- **Porter, Michael 4**
- Procter & Gamble (PG) 42, B2
- Prometheus Global Media 54
- Providence Equity Partners 42
- **Putin, Vladimir 12**
- **Putnam, Robert D. 4**

**Q R S**

- **Qaddafi, Muammar 4**
- **Qaddafi, Saif al-Islam 4**
- QVC 19
- Razorfish 54
- Renaissance Capital 12
- Renesas Electronics 18
- Research Affiliates 41
- Rhodia 42
- Right Angle Sports 75
- Robert Bosch 20
- **Rockefeller, David 78**
- Roubini Global Economics 8
- **Rubin, Robert 86**
- Saab Automobile 20
- Samsung Electronics B15
- Samuel Adams (SAM) B18
- Sanford C. Bernstein (AB) 19
- **Santana, Carlos 54**
- **Schultz, Howard 52**
- **Schumer, Charles E. B18**
- **Schwartz, Alan 54**
- **Seidenberg, Ivan G. 52**
- Sephora 19
- SFR 42
- Sharp Group 75
- **Shirakawa, Masaaki 37**
- Siemens Enterprise Communications 39
- **Simioni, Denis 19**
- Smithfield Foods (SFD) 18
- **Smith, Liz 78**
- SNL Kagan 80
- **Snowe, Olympia J. B18**
- **Snyder, Rick 26**
- Solvay 42
- Sony (SNE) 16, B15
- Sotheby's (BID) 42
- Southwest Airlines (LUV) 21, 62
- Sprint Nextel (S) 21
- SRA International (SRX) 42
- **Stabenow, Debbie B18**
- Stagecoach Group 62
- Starbucks (SBUX) 52
- **Stata, Ray B4**
- Statistics Sweden 20
- Street Strategies B4
- **Summers, Larry 4**

**T U V**

- Target (TGT) B4
- Tax Analysts B4
- Tesco 88
- Texas Instruments (TXN) 42
- Gores Group 39
- Time Warner (TWX) 16
- **Tisch, Jonathan 78**
- Tjintokk 20
- **Tourre, Fabrice 86**
- Toyota Motor (TM) 20
- TPG 39
- Trailways 62
- Tribune 50
- T. Rowe Price (TROW) 42
- **Trumka, Richard B14**
- Twenty-First Securities 50
- Tyco Electronics (TEL) 39
- Tyson Foods (TSN) 18
- UBS (UBS) 12, 14
- Vale (VALE) 21
- Variety 54
- Verizon (VZ) 52
- Versace 54
- Visteon (VC) B15
- Vivendi 42
- Vodafone (VOD) 42
- Volkswagen 20

**W Y Z**

- **Walker, Scott 26**
- Wal-Mart Stores (WMT) 88, B2
- Walt Disney (DIS) 54
- **Weingarten, Randi 26**
- Wells Fargo (WFC) 25, B16
- Wenner Media 54
- Westwood One (WWON) 39
- **Wood, Patti 78**
- **Woods, Tiger 21**
- Wright Medical (WMGI) 21
- WSL Strategic Retail 19
- **Wyden, Ron B4, B18**
- YouTube (GOOG) 32
- Yukos 12
- **Zalaznick, Lauren 80**
- **Zell, Sam 50**
- ZenithOptimedia 54




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## Corrections & Clarifications

● "Abu Dhabi Plans to Go Nuclear" (Energy, Apr. 4-Apr. 10) gave an incorrect title for Bruce Smith. He is an adviser to the Abu Dhabi Water & Electricity Authority. ● In "Harry & David Kicks the Basket" (Markets & Finance, Apr. 4-Apr. 10), we wrote that FedEx landed DC-8 cargo planes in Medford, Ore. The DC-8s were not owned by FedEx.

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# Opening Remarks





# Extreme Makeover

What was lost when some of America's finest scholars got paid to buff Qaddafi's image?
By Paul M. Barrett

In 2006 and 2007, a dozen Western intellectuals traveled to the North African desert for intimate conversations with the man who likes to call himself the Brother Leader. Muammar Qaddafi received his visitors in a carpeted Bedouin-style tent, where they sat on plastic chairs and sipped tea while discussing the dictator's thoughts on economics and politics.

The meetings were arranged by the Monitor Group, a Cambridge (Mass.) consulting firm co-founded in 1983 by Michael Porter, the Harvard Business School management expert. As Politico first reported on Feb. 21, the Qaddafi regime paid Monitor a fee of $3 million a year, plus expenses, to run what the firm called "a sustained, long-term program to enhance international understanding and appreciation of Libya." Monitor, which has 1,500 employees worldwide, organized roundtables and produced thick studies on stimulating business in the isolated oil state. It provided research for a PhD thesis Qaddafi's son Saif al-Islam submitted to the London School of Economics.

At one point, the firm proposed a mass-circulation book–for an additional price of $2.45 million–that according to a Monitor memo would "allow the reader to hear Qaddafi elaborate, in his own words and in conversation with renowned international experts, his core ideas on individual freedom, direct democracy vs. representative democracy, [and] the role of state and religion."

The book never materialized, but Monitor succeeded in generating plenty of positive press for Libya. In an interview with *Businessweek* in February 2007, Porter said Saif Qaddafi had helped arrange Monitor's engagement with Libya. "I have gotten to know Saif quite well," Porter said. "He was a doctoral candidate at the London School of Economics, where he studied with some of the best professors. He's very much oriented toward making Libya a member of the modern world community."

Monitor brought Benjamin R. Barber, then a professor at the University of Maryland, to Libya for three visits. On Aug. 15, 2007, Barber published an opinion article in *The Washington Post* entitled "Qaddafi's Libya: An Ally for America?" Although "written off not long ago as an implacable despot," Qaddafi "is a complex and adaptive thinker," Barber asserted, "as well as an efficient, if laid-back autocrat." Joseph Nye, a professor at Harvard's Kennedy School of Government, also met Qaddafi. In December 2007 he published an essay in *The New Republic* in which he described the ruler of Libya since 1969 as "an autocrat" and a past "sponsor of terrorism," but also a man of ideas, "actively seeking a new strategy" and interested in "direct democracy."

Now that Qaddafi has vowed to hunt

PHOTO ILLUSTRATION BY MAAYAN PEARL; FOTO24/GALLO IMAGES/GETTY IMAGES

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down and kill every last dissident in Libya, Monitor's image-buffing campaign has received probing coverage in *The Boston Globe* and *Mother Jones*, and the firm has issued an online apologia. "Given the terrible spectacle of Colonel Qaddafi using force on his own people, it may be difficult to imagine that just a few years ago many saw a period of promise in Libya," the firm said on Mar. 24. "Colonel Qaddafi had renounced terror, forfeited nuclear and chemical weapons and programs, and declared himself ready to rejoin the community of nations."

**An idea in the abstract may thrill its** creator, but an idea that has been tested by reality–and survives intact–can change the world. That's why academics who descend from the ivory tower and subject their theories to the complications of modern life deserve applause. Provided, of course, that their motivations remain pure. Recent history suggests that's a tricky line to walk.

A generation of Ivy League economists was enjoying both professional esteem and financial industry paychecks until the Wall Street crisis of 2008 made them look pretty dumb, if not venal. The Academy Award-winning documentary *Inside Job* offered a bipartisan parade of these men–for example, at Harvard, Larry Summers, a Democrat who opposed more oversight of derivatives, also collected generous speaking fees from investment banks, while Frederic Mishkin, a George W. Bush appointee to the Federal Reserve who teaches at Columbia, was paid to co-author a 2006 report praising the Icelandic financial system, which subsequently collapsed.

The same could be said for the academics who journeyed to Libya. It's true that between 2006 and 2008, when Monitor said it did the bulk of its work, the country's trajectory seemed positive. The U.N. had lifted sanctions in 2003, and the U.S. had resumed full diplomatic relations in 2006. The families of victims of the Libyan-engineered Pan Am-Lockerbie bombing of 1988 were paid hundreds of millions of dollars in settlements.

None of that excuses the use of august academic reputations and affiliations to promote the Qaddafis. Monitor partner Eamonn Kelly said in an e-mail to *Bloomberg Businessweek* that the firm regrets "our research in support" of Saif Qaddafi's doctoral thesis. "We also regret the proposal submitted to write a book under Colonel Qaddafi's name. Although this work was not completed, the very idea was a mistake." Kelly said he is leading an internal investigation that includes whether Monitor engaged in lobbying without having registered to represent Libya.

What Monitor did is no different from what K Street "public affairs" shops do every day of the week for dubious foreign governments. Still, the Libya episode leaves a distinctive odor, one that emanates from the corruption of academic reputation. Harry Lewis, a computer science professor at Harvard, doesn't like the smell. During a faculty meeting on Apr. 5, he asked the university's president, Drew Faust, "Shouldn't Harvard acknowledge embarrassment, and might you remind us that when we parlay our status as Harvard professors for personal profit, we can hurt both the university and all of its members?" Faust responded that she supports such expressions of concern but also endorses "the wide discretion of all of you in this room ... to pursue the directions of academic inquiry you choose, and the outside activities and engagements you choose."

Harvard's Nye rejects suggestions that he, for one, ought to apologize for anything. Now a university distinguished service professor, the defense-policy expert explains in an interview that he visited Tripoli in hopes of nudging Qaddafi toward moderation and encouraging Libyan reformers. *The New Republic* essay was his idea, not Monitor's, he says, and he disclosed to the magazine that he had been hired by the consulting firm. Nye won't say what he was paid, citing a confidentiality clause. "I am confident that I did not cross any ethical red line," he adds. "I have never supported Qaddafi, and I'm on record supporting President Obama's actions to try to push him out."

Professors of Nye's rank do not have to schlep to Tripoli to collect a consultant's fee. He says he does about a half-dozen paid outside gigs a year, mostly for management-consulting firms and corporations. Beyond the extra money, it's got to be flattering to have a head of state–even an erratic tyrant–show curiosity about your work. Nye wrote that when he visited Qaddafi's tent, the dictator had five of the professor's books on hand, including *Soft Power: The Means to Success in World Politics*. Qaddafi, he wrote, "seems to have become interested in soft power–the art of projecting influence through attraction rather than coercion." In due time, Qaddafi would demonstrate his abiding attachment to coercion.

Fascination with Nye's theories spilled over to the next generation of Qaddafis. Saif wrote about soft power in his PhD thesis, which was accepted by the London School of Economics (LSE) in 2008. In his acknowledgments, the younger Qaddafi thanked Nye for his advice, according to an online copy of the dissertation.

Nye says he read and commented on only one chapter, something he says he routinely does for those who write about his theories. The LSE said in March it is investigating whether Saif plagiarized parts of his thesis–a controversy Nye says he knows nothing about. In 2009, after awarding Saif his doctorate in philosophy, the LSE accepted a pledge for a £1.5 million ($2.5 million) donation from a charity run by the Qaddafi son, as well as another £1.5 million as part of a contract to train future Libyan leaders. Howard Davies resigned last month as director of the LSE, admitting that the arrangements with Libya had hurt the school's reputation.

Porter canceled an interview with *Businessweek*, citing class-preparation duties. Barber, now a distinguished senior fellow at Demos, a New York think tank, did not respond to requests for comment.

At least one Monitor superstar confesses to chagrin about Libya. Robert D. Putnam, a professor of public policy at Harvard, spent several hours with the colonel in January 2007. "My hosts were willing to pay my standard consulting fee, and to be honest, I was curious," Putnam wrote in *The Wall Street Journal* on Feb. 26. Accompanied by his wife, Rosemary, Putnam spoke with Qaddafi about "how the development of civil society might be applied to democratic reform in Libya." Still, Putnam couldn't tell: "Was this a serious conversation or an elaborate farce?"

"I came away thinking–hoping–that I had managed to sway Colonel Qaddafi in some small way, but my wife was skeptical," Putnam says. Two months later, he was invited back to Tripoli. "But by then," he wrote, "I had concluded that the whole exercise was a public-relations stunt, and I declined."

One lesson from the Monitor fiasco is that the scholar is wise who listens to his wife. Another is that, whatever its financial appeal, flattery for hire has no place on the CV of a serious academic. B



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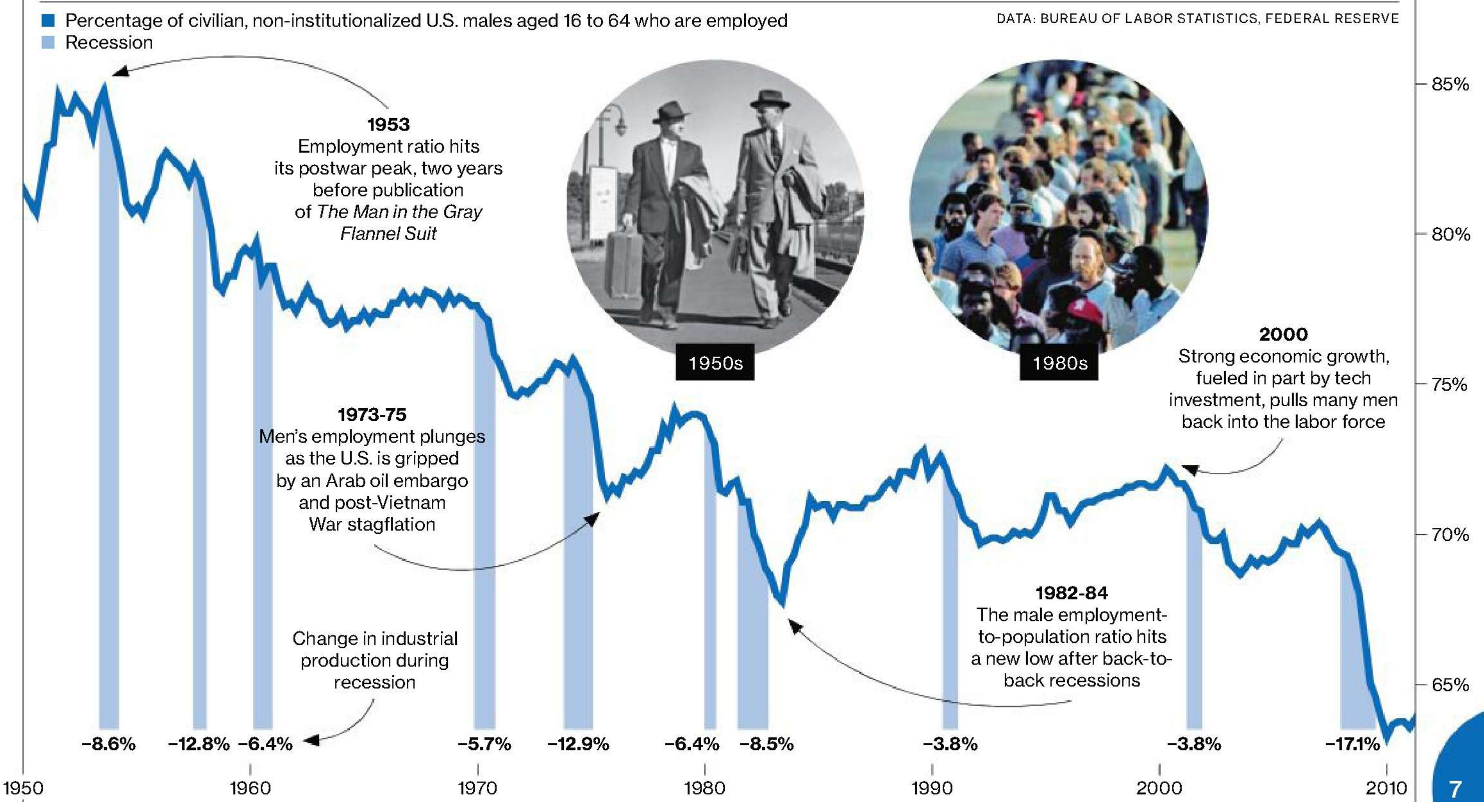



*A data visualization of emergency incidents in Madrid between 2009 and 2010*

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Contents ▶ Mideast instability unsettles oil traders 8 ▶ Thailand shrinks its rice bowl 9 ▶ Abu Dhabi's bet on chips 10 ▶ China tamps down on luxury ads 11 ▶ Tom Keene talks with emerging markets specialist Bhanu Baweja 12 ▶ Medvedev's Kremlin shakeup 12 ▶ The week ahead 14 ● Edited by Christopher Power



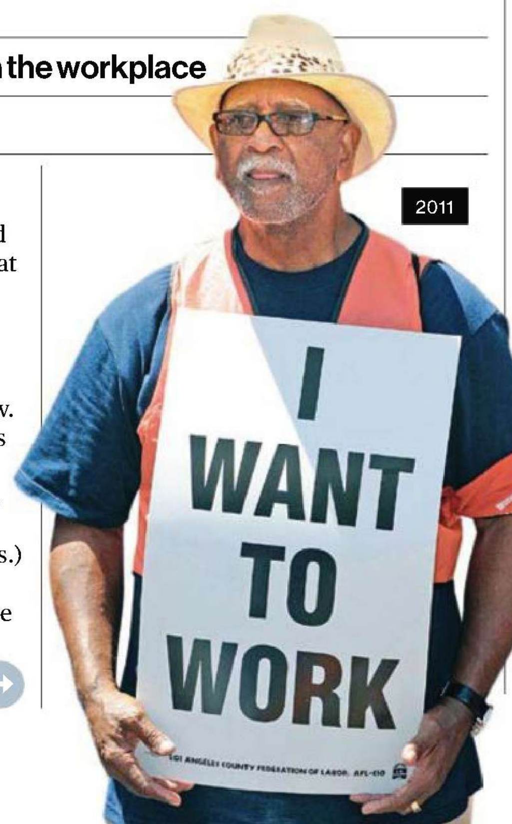





# The Hidden Job Crisis For American Men

## ▶ Over the past 60 years, men have gradually disappeared from the workplace

## ▶ "It's not healthy for me. People were designed to work"




CLOCKWISE FROM TOP: GETTY IMAGES; PHILIP GOULD/CORBIS; MARK RALSTON/AFP/GETTY IMAGES

The March jobs report released on Apr. 1 seemed like the best in years. Labor Secretary Hilda L. Solis released a statement noting that the four-month drop in the jobless rate, to 8.8 percent from 9.8 percent, was "its largest decline since 1984."

Behind the headlines, though, statistics on jobs are far less encouraging. Yes, job growth has picked up somewhat. Yet an equally important reason for the lower jobless rate is that many people, men in particular, have simply given up looking for work and are no longer counted among the unemployed. Some sit at home. Some have become homeless. Rather than paying taxes on labor income, they are drawing government benefits, or relying on family and friends for support.

Economists are concerned that the recovery will extend an ominous trend of disengagement for male workers that stretches back six decades. The share of American men aged 16 to 64 who are employed has fallen in a sawtooth pattern, from nearly 85 percent in the early 1950s to less than 65 percent now. As the chart above shows, the rate falls steeply in recessions and does not get back to its previous high in recoveries. (Women's employment-to-population ratio has trended higher over the years.)

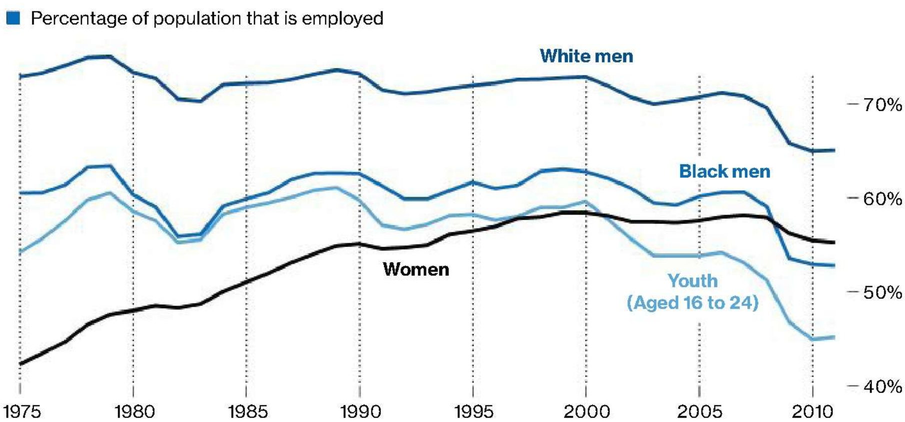
The downward ratchet for men could be more severe this time because the slump has been worse. "I'm quite worried," says David Autor, an economist at the Massachusetts

WorldMags

# Global Economics

### Decades of Progress and Regress

Women are working more than they were decades ago, white and black men less. The youth employment-to-population ratio has tumbled.




DATA: BUREAU OF LABOR STATISTICS

Institute of Technology. Absence from the labor market is bad for men, their families, the economy, and government finances, says Autor. "It's really a significant concern for a whole host of reasons," he says.

Some workers who might have done fine in a normal job market suffer a blow from a long-lasting recession from which they can't recover. They may lose skills and confidence. They may fall out of touch with friends and colleagues who could help them find jobs. The unluckiest may become homeless or addicted to drugs or alcohol, making it hard to reenter the labor force even when recovery comes.

Kimani Porter, 19, who lives with his mother and three younger brothers in Englewood, N.J., retains the hopefulness of youth. He wants a job and thinks he could do well: "I'm real talented," he says. But he was expelled from high school for fighting and then fired from a construction job with a relative because "I was being too lazy," he says. In the late 1990s, employers might have given him another chance. The jobless rate for black male teens was under 30 percent then, vs. over 40 percent in March. Now Porter applies for jobs and hears nothing.

It's not just the young who suffer. Christopher J. Lee, 55, of New Rochelle, N.Y., lost a $52,000-a-year job in corporate travel in July 2009 and hasn't found work since. His extended unemployment benefits run out this summer. "I've been sitting around and it's debilitating," he says. "It's not healthy for me. People were designed to work." A Bureau of Labor Statistics study found that many older workers who lose jobs never go back to work again. Of those aged 55-64 who were displaced from 2007 through 2009, 21 percent were out of the labor force as of January 2010. "I have heard some people say, 'It's not necessarily a bad thing. Maybe people are just making voluntary decisions about work-life balance,'" says Michael Feroli, chief U.S. economist for J.P. Morgan Securities. "In principle that's possible, but all of a sudden people wanted more work-life balance? I don't think so."

Typically the unemployment rate stays flat or even rises when the economy begins to recover. People reenter the labor force. If they don't find a job right away, they are counted among the unemployed. There is no flood of reentrants this time, at least not yet. The male labor force—those employed or seeking work—has actually shrunk 0.7 percent since the male unemployment rate peaked at 11.4 percent in October 2009. That's one reason the jobless rate for males was down to 9.3 percent in March.

One glimmer of good news for men: The number of males who are employed has rebounded more than the number of women employed since the trough of employment—up 2.1 percent, vs. 0.6 percent for women (page 26). Yet because men's employment fell so much further to start with, it is still off 5.6 percent from its late 2007 peak, vs. a 3.5 percent decline for women.

A tighter labor market would force employers to consider a wider range of candidates. Vibrant growth is hard to achieve, though. Autor favors more vocationally oriented "career academies" to serve students unlikely to go to college. For would-be employees such as Kimani Porter, that can't come too soon. —*Peter Coy*

***The bottom line*** *The effects of the "mancession" on the male American workforce will be felt well into the recovery as some men stay stuck in unemployment.*

# 8.43

PERCENT

**Yield on Portuguese 10-year government bonds on Apr. 6, the day Prime Minister José Sócrates asked the EU for a bailout. Portugal's borrowing costs have soared since late March.**

DATA: BLOOMBERG

**Energy**

## Oil Traders Count on Instability to Last

▶ The risk premium is rising as traders figure the turmoil will last

▶ "They are all failed states. I [see a] ... chance of contagion spreading"

The Mideast uprisings and a recovering world economy have pushed oil prices to the highest levels since 2008: $121 recently for Brent crude. Yet except for Libyan crude, which provides 2 percent of world supplies, oil is flowing unimpeded.

Still, traders are focused on a new perception that an Age of Uncertainty

FROM TOP: BOGDAN CRISTEL/REUTERS/CORBIS; PAULA BRONSTEIN/GETTY IMAGES

Video pirates keep piling up the loot page 16 ▶





has arrived in the Mideast that isn't going away anytime soon. Hakan Kocayusufpasaoglu, an oil trader who runs hedge fund Archbridge Capital in Zug, Switzerland, puts it bluntly: "They are all failed states," he says of the oil producers. "I think there is a decent chance of the contagion spreading." He says prices are headed toward $150 a barrel.

Before the uprisings, traders assumed that oil was readily available from reliable sources. Now the need to replace Libyan oil, plus fast-rising world demand, has pared OPEC's spare capacity to perhaps 3.3 million barrels per day, from around 6 million barrels last year, figures Amrita Sen, an analyst at Barclays Capital in London.

Longer-term, leadership changes in Egypt and possibly Libya could mean stiffer financial terms for international oil companies operating in those countries. Even wealthy states such as Saudi Arabia, which face no dire threats now, are likely to find it ever more expensive to satisfy the needs of their youthful populations.

Saudi Arabia's King Abdullah recently promised $150 billion in new housing, wage increases, and other benefits. These deals mean the kingdom needs oil at $85 to $90 per barrel to balance its budget—a huge increase from around $25 per barrel in 2003, figures Rachel Ziemba, an analyst at Roubini Global Economics in London. "The social contract is becoming less and less sustainable," she says, adding that as the fiscal pressure builds, Saudi Arabia may no longer be so willing to play the role of swing producer, pumping new crude when it's needed to cool the market.

What does this mean for prices? "There is a $15-to-$20 unrest and fear premium in the market," says Ray Carbone, president of Paramount Options in New York and a trader at the New York Mercantile Exchange. "We wouldn't see the premium evaporate if Muammar Qaddafi left Libya tomorrow. I don't see us returning to where prices were anytime soon." Goran Trapp, Morgan Stanley's chairman of oil liquids in London, one of the firm's trading groups, says the risk of real disaster, such as a Saudi-Iran war, is not even priced yet into the market. —*Stanley Reed, Mark Shenk, and Grant Smith*

***The bottom line** Oil traders believe that a new era of turmoil will lock a high-risk premium into the price of crude for the foreseeable future.*

Food

# The Thai Rice Bowl May Get a Little Skimpier

▶ The world's biggest rice exporter faces stiffer competition

▶ "Cutting the supply may lead to food shortages"

Many Thais revere Me Posop, the rice goddess who guards humankind and rewards good stewards of her grain. Me Posop has been kind to Thailand in recent decades. While its neighbors Vietnam, Myanmar, Cambodia, and Laos struggled through war, Marxist-Leninism, and authoritarian rule, Thailand prospered from its new factories and booming rice exports. The nation surpassed Myanmar as the world's top rice shipper in 1965: Last year 9 million tons of Thai rice were exported around the world. Thailand, like the Saudis in oil, became the key producer, the country that could always moderate global prices with its abundant reserves. This year, while corn and wheat prices have reached new highs, ample stockpiles of Thai rice have driven rice prices down.

Now the Thai government is proposing a major change in strategy for its rice growers, who feel hard pressed by low prices, an assault of pests, and the presence of low-cost competition from emerging rivals. The government seems ready to abandon Thailand's position as the world top rice exporter—a serious decision, considering the mounting anxiety over the size and stability of the global food supply.

Thai farmers are certainly worried about their business. In the rice paddies near Ayutthaya, a former Siamese capital that 17th century emissaries from Louis XIV compared with Paris in its wealth and importance, Payao Ruangpueng must battle an infestation of rice planthoppers that are munching their way through the paddies. That's not all. "We're suffering from a rice price slump, crop damage, and lower-than-expected production," she says, standing on the edge of a rain-soaked paddy. "Production costs are higher than income. We can't afford to continue planting."

In March the Thai government stated its intention to eliminate a third planting this year to improve rice quality and to combat the hopper, which dies if deprived of rice plants for 25 days. The plan may eventually reduce annual exports by 2 million metric tons, or about 20 percent of Thailand's shipments.

Thai officials say they want the industry to focus on fancier grades of rice that fetch higher prices. While Thai rice shipments have increased 33 percent in the past decade, Vietnamese exports are up 70 percent in the same period to 6 million tons, according to the U.S.



Loading a ship in Bang Pakong, Thailand, with 1,000 tons of rice bound for Africa



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**Tsunami Wreckage and the Threat to Shipping** *Houses, cars, and tractor-trailers washed out to sea by the 28-foot tsunami in March are clogging shipping lanes off Japan, posing a bigger challenge to commercial shipping lines than the leaking Fukushima Dai-Ichi nuclear plant. As of Apr. 4, Japan's coast guard was advising ships to stay 90 nautical miles (167 km) off the worst-hit stretch of coast. —Chris Cooper*



**With costs of land, tractors, and farmhand wages rising, Thailand has priced itself out of much of its market**

Agriculture Dept. Cambodia and even Myanmar are also emerging as global rice powers, says Pramote Vanichanont, honorary president of the Thai Rice Mills Assn. and a member of the National Rice Policy Committee. Thailand, following the classic curve of development, has priced itself out of much of its own market, he says. Land prices have shot up, as well as the cost of tractors and the wages of farmhands.

The government also plans to turn the country into the warehouse, finance, and marketing hub of Southeast Asia's rice trade. The Agricultural Futures Exchange of Thailand, the nation's government-backed rice and rubber bourse, is rolling out a new futures contract on Apr. 29 intended to be a regional benchmark for standard quality rice.

This long-term strategy may not be good for global food needs. The U.N. expects world food demand to rise 70 percent by 2050, and its Food and Agriculture Organization in February urged Thailand and its neighbors to grow more rice. Reductions in Thailand's production may end up hurting poor consumers in Africa and elsewhere while doing little for Thai prices, says Kiattisak Kanlayasirivat, a director at the Thai office of trading company Novel Commodities. "I doubt whether it is a good policy, as cutting the supply may lead to food shortages," says Kanlayasirivat, whose firm trades about $600 million of rice a year.

The Vietnamese may not even have the resources needed to replace major cuts in Thai production. "I personally think that Vietnam doesn't need to become No. 1 in rice exports," says Nguyen Van Bo, president of the Vietnamese Academy of Agricultural Science. "To export a lot, Vietnam will have to exploit a lot of land, use a lot of fertilizers. That could cause degradation of natural resources." *—Alan Bjerga and Supunnabul Suwannakij*

***The bottom line*** *While Thailand is the world's top rice exporter, falling prices and rising competition may lead to a strategic decision to abandon that role.*

**Development**

## Abu Dhabi's High-Tech Bet to Avoid Tumult

- **The emirate's giant fund is doubling its outlay on a global chip venture**
- **"In Abu Dhabi right now there is no burning platform"**

Less than 300 miles from where Bahrain's royal family faces a youth-led uprising, Ibrahim Ajami is trying to foment a different kind of revolution among the students of Abu Dhabi, the capital of the United Arab Emirates. Ajami, 36, runs Advanced Technology Investment, a division of Mubadala Development, the state fund that has invested billions of the emirate's oil and gas wealth in businesses that are supposed to perpetuate the city-state's prosperity–and peace–long after its crude has run out. Two years ago, Ajami, a former Occidental Petroleum executive, helped broker a Mubadala-financed deal that merged

FROM LEFT: KEITH BEDFORD/REDUX; NELSON CHING/BLOOMBERG

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**$5 BILLION**
**Average cost of building a microprocessor plant**

the manufacturing side of **Advanced Micro Devices**, the U.S. chipmaker and archrival of **Intel**, with Chartered Semiconductor Manufacturing, Singapore's contract chip business. The result: **GlobalFoundries**, the third-largest contract chip manufacturer in the world, with plants in Asia, Europe, and the U.S., and an 86 percent stake held by Mubadala. In January, not long before the uprisings that engulfed Egypt and Libya, GlobalFoundries announced plans to double spending on new plants and equipment to more than $5.4 billion in 2011.

GlobalFoundries, which had $3.5 billion in revenue in 2010, packs a lot of punch. "They are coming to the market with state-of-the-art plants," says Jim McGregor, an industry analyst at research firm In-Stat. "Only a handful of people can do the high-end stuff, and there's increasing demand for that." Abu Dhabi hopes to have a chip plant up and running in the emirate itself by 2015: The plan is to build a tech complex that will also attract chip-design and software companies.

Before that can happen, though, the city has to develop a workforce capable of competing with chip workers worldwide. "You need the roads, the infrastructure, and the power and the water. You need the right regulatory environment," says Ajami. "More importantly, you need the talent."

GlobalFoundries is now largely run by Americans. Yet the Abu Dhabi government is convincing students like Sara Al Braiki that their brightest prospects lie in electronics and not in the petrochemical industry. "We need innovation. We need to think in different ways," says Al Braiki, a mechanical engineering student at United Arab Emirates University. Al Braiki was one of 60 students who spent four days last year in Dresden, Germany, touring semiconductor plants and meeting with engineers and executives. She also notes that her group was split evenly between men and women, notable in a largely male-dominated region.

While Mubadala, whose investments run the gamut from Formula 1 to buyout giant **Carlyle Group**, can bankroll GlobalFoundries' ambitions, Ajami says Abu Dhabi's wealth may also prove an obstacle. Unlike Taiwan and Korea—which he's studying to learn how smaller countries can break into new industries—Abu Dhabi doesn't have the threat of national extinction driving its people to throw themselves behind economic development, he says. The United Arab Emirates had a per capita gross domestic product of $57,744 in 2009, ahead of the U.S. and Japan. "In Abu Dhabi right now there is no burning platform. People are comfortable," he says. Ajami and other Abu Dhabi officials say they want to toughen the emirate's people by exposing them to demanding businesses.

Contract chip manufacturing certainly fits the bill. A microprocessor—the kind of chip made by the AMD factories that were acquired—packs more than a billion transistors into a device the size of a thumbnail. Some of the layers deposited on discs of silicon during their manufacturing are just one atom thick. It takes an average of two years and $5 billion each to build and equip the plants that make these and other chips. In this highly cyclical industry, chip demand can fall off in a few months, so the consequences of missing production deadlines or making the wrong product are severe. AMD reported cumulative losses of more than $6 billion in the three years before the sale of its plants was completed in 2009.

The record of Gulf states in weaning themselves off oil economies isn't good, says Kristian Coates-Ulrichsen, who teaches Arab politics at the London School of Economics. Oman and Bahrain are more than halfway through their 25-year plans to end their citizens' dependence on state jobs. Yet their progress has been slow, he says. Unless the ruling families of the prosperous Gulf states can modernize their economies, they risk the kind of unrest that overturned governments elsewhere in the Arab world. "The Gulf has already shown it's not going to be immune to these forces," says Coates-Ulrichsen.

*—Ian King and Jason Kelly*

***The bottom line*** *Abu Dhabi hopes to build a successful chip industry as part of a bid to avoid the turmoil that has bedeviled other Arab regimes.*

Consumption

## China's Ad Business Faces a Crackdown

▶ Luxury ads in Beijing must be a lot less luxurious: Drop the "royal"

▶ "The voice of the people is getting stronger and stronger"

"Hedonism, lavishness and the worship of foreign things" won't be tolerated. Nor will promoting "aristocratic lifestyles."

A new ban on these themes in outdoor advertising takes effect on Apr. 15 in Beijing, according to an announcement on the website of the city's industry and commerce bureau. The restrictions are likely to be rolled out in cities across China as part of what could prove to be a nationwide crackdown on conspicuous consumption, says Shanghai-based Jim Liu, managing partner at outdoor advertising agency Kinetic China.

Why the new Puritanism? China is the world's second-largest luxury goods market and is on track to pass Japan as No. 1 by 2015, predicted China Commerce Minister Chen Deming on Mar. 7. Sales of Ferraris grew 50 percent last year. Lamborghini sales tripled, while sales of Louis Vuitton handbags, Hermès scarves, and Omega watches keep growing rapidly. The retail value of China's luxury market could more than double in five years to $27 billion, McKinsey wrote in a Mar. 8 report. Although the Chinese love



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↓
"A high-end luxury sedan Infiniti M. Enjoy driving into new territory"



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# Tom Keene's EconoChat

Tom talks with **Bhanu Baweja,** global head of emerging markets for UBS, about risks and rewards around the world.

**Has there been any slowdown in money flowing to emerging markets?**
In the beginning of the year, we did see some investors take back some money. But in the big scheme of things, that is really just a squiggle.

**Why is that?**
We have seen money flowing into emerging markets for the better part of 10 years, and they have outperformed developed markets. I still think we are pretty early in the game.

**How should you play emerging markets?**
Unlike the 1980s, you have emerging market balance sheets in pristine shape. Governance in several places is improving. We certainly think that direct exposure to emerging markets through China, through Russia, makes a lot of sense. You do have to pick your spots, because asset prices have gone up a fair way. We also have been identifying U.S. companies that have exposure to places like South Asia which will do extremely well.

**What about the risk?**
From an economic standpoint, the risks are much higher in the developed markets. From a political standpoint, there are greater risks in emerging markets. But emerging markets compensate you for that in terms of higher return. So on a risk/reward basis, I still think that EM equities make more sense. Emerging market debt, I think, has already had its day. Ⓑ



*Tom Keene hosts* Bloomberg Surveillance *7-10 a.m. ET on XM 129 and Sirius 130.*

luxury, officials value social stability more. "We are keenly aware that we still have a serious problem in that our development is not yet well balanced, coordinated, or sustainable," Premier Wen Jiabao told delegates to the National People's Congress on Mar. 5. China's Gini coefficient, a measure of income distribution, has risen from 0.3 a quarter century ago to nearly 0.5 today, a level commonly cited as socially destabilizing, according to Li Shi, a professor at the School of Economics and Business at Beijing Normal University.

If social unrest looks more likely, it makes sense to mute celebrations of wealth. Luxury ads are an easy target, so media agencies are scrambling to review their copy. Words such as "imperial" or "royal," often used by sellers of luxury villas, ad copy suggesting "lavishness" or "premium" used by some high-end vehicle makers, and any phrase suggesting a brand is No. 1 are all potential problems.

As part of China's tightly regulated media business, ad strictures already block everything from pharmaceutical companies using doctors (or actors appearing as medical staff) in their jingles to too-overt use of the Statue of Liberty, says Charley Kan, Beijing-based national creative director for media agency MEC Access China. Beijing even has a ban on companies using the phrase *zhongyang*–literally "central." Pretty inoffensive–except that *zhongyang* is shorthand for top leaders or the central government, says Yi Caigen, Beijing-based marketing and sales department deputy head at property developer HKI China Land.

Yi isn't that worried. Unlike smaller real estate firms, he says, "We don't need to say we are the best or No. 1. We have a reputation we can stand on." Still, HKI is making changes. Use of the word *huang*, or royal, may stop. Traditional characters on billboards for Yujintai, Beijing's most expensive luxury residence, will be dropped. Such characters, with elaborate script, evoke the pre-revolutionary past and are frowned on. Showiness can arouse popular resentment, particularly among China's outspoken netizens, says Yi. "The voice of the people is getting stronger and stronger," he says. "And when the government hears from them, it has to act." *—Dexter Roberts*

***The bottom line*** *Chinese officials want to play down the glaring differences between China's haves and have-nots. Luxury ads will soon be tamped down.*

Corruption

## Separating the State And the Boardroom



▶ Russia's Medvedev kicks top officials off state company boards

▶ "It's very significant, it's a small revolution"

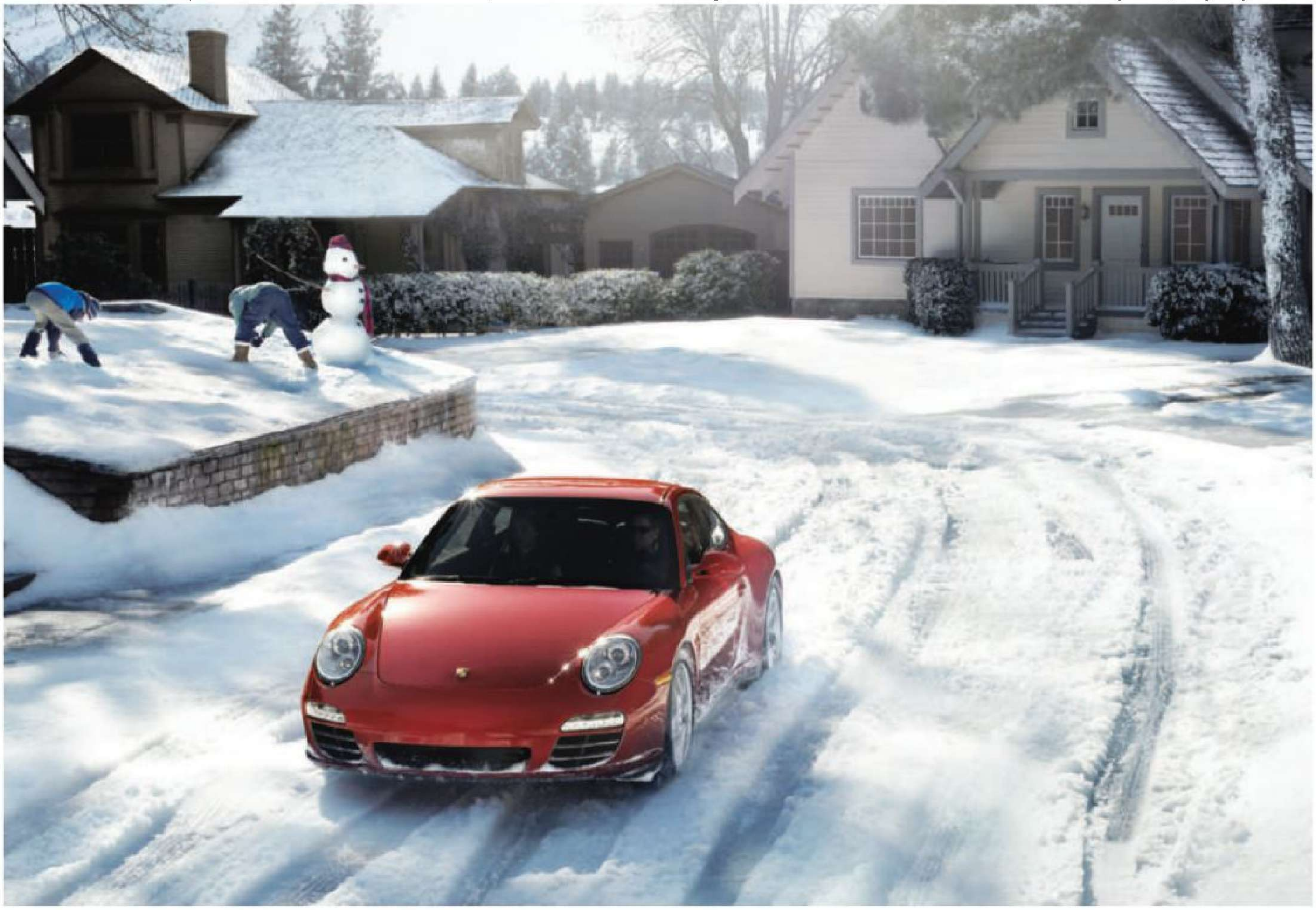
Igor Sechin, 51, is Russia's Deputy Prime Minister. He's also chairman of state-controlled Rosneft, Russia's largest oil company. Unofficially, Sechin is one of the *siloviki*, the "men of power" who often have security backgrounds and rose to prominence during Vladimir Putin's presidency. Although Putin is now technically No. 2–he's Prime Minister to President Dmitry Medvedev–he and his allies still have plenty of clout.

On Apr. 2, Medvedev upset this arrangement. He announced that eight top ministers would step down from the boards of companies that they also regulate as Cabinet members. The officials affected include, among others, Deputy Prime Ministers Sechin and Alexei Kudrin and First Deputy Prime Minister Viktor Zubkov. They must be off these boards by July 1 and replaced by independent directors. Sechin and the others will stay in the government. In addition, by Oct. 1 steps must be taken to remove all other top state employees from the boards of public companies.

On Apr. 5 the Russian daily *Kommersant* published a list of candidates for the state company boards, citing unidentified government officials. They include the head of **Morgan Stanley**'s Russian subsidiary, who may replace Sechin at Rosneft, and **Ernst & Young**'s country managing partner, who could take over from the energy minister on pipeline operator Transneft's board, according to the newspaper.
Morgan and E&Y could not return

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## Global Economics

calls seeking comment in time.

Medvedev's move shocked and delighted local corporate governance advocates. "It's very significant, it's a small revolution," says activist shareholder Alexey Navalny. "His idea is really supported by business, by civil society." Russian billionaire Alexander Lebedev, owner of the U.K.'s *Evening Standard* and *Independent* newspapers, says he fully supports Medvedev's initiative. Asked if Putin is likely to have given full backing to Medvedev's order, Lebedev replied: "As Prime Minister, he has to carry it out, it doesn't matter what he thinks." Putin hasn't commented on the directive.

Medvedev, 45, a lawyer from St. Petersburg, replaced Putin as President in 2008 because the constitutional limit on more than two consecutive presidential terms required Putin to leave office. Putin, 58, an ex-KGB officer, has nonetheless kept most of the power. The Apr. 2 directive could affect this structure. "This risks triggering a war between the elites," says Alexei Mukhin, director of the Moscow-based Center for Political Information, a research group. "It will mean a real conflict with Putin." Russia holds presidential elections next March; it still isn't clear who will run.

Medvedev has tried to widen Russia's investment appeal beyond energy to speed up economic growth. Many western investors are wary of Russian stocks, fearing that Russia does not provide shareholders enough legal protection. Rosneft, for example, trades at a price-earnings ratio of 8.8; **ExxonMobil** trades at a p-e of 13.6. Rosneft acquired many of its oil assets from **Yukos**, the private Russian oil company that the Kremlin dismantled after its main owner, Mikhail Khodorkovsky, was found guilty of tax evasion and sent to a Siberian prison.

Now it's time to see how Medvedev follows through. "There is a skeptical view that this is window dressing because they know they have control of the companies whether they are formally in charge or not," says Charles Robertson, investment bank Renaissance Capital's chief global economist in London. "But there is an alternative view that the authorities recognize that Russia is at risk of stagnating over a number of years without change." —*Henry Meyer*

***The bottom line*** *Russian President Medvedev may be starting a new push for shareholder rights by removing state officials from top corporate boards.*



Events of note in the week ahead

# Seven Days

by Ira Boudway

**11**

Alcoa earnings



▶ **Honda recovery:** Japan's third-largest automaker plans to reopen its Sayama and Suzuka plants at half capacity as the industry begins to recover from the Mar. 11 earthquake and tsunami.

**12**

Germany's consumer price index

Brazil's retail sales



▶ **U.S. trade balance:** Rising oil prices helped drive the trade gap to $46.3 billion in January. Surveyed economists expect a $43.1 billion gap for February.




**13**

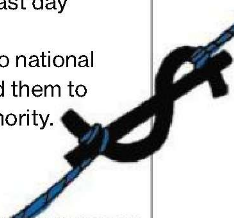



Federal Reserve Beige Book

Earnings from JPMorgan Chase

▶ **Stress test deadline:** The last day

the results of stress tests to national regulators, who will forward them to the European Banking Authority.



**14**

China's first-quarter GDP



▶ **BRICS meeting:** China's President Hu Jintao hosts leaders from the other top emerging economies—Brazil, Russia, India, and South Africa—on the island province of Hainan.

**15**

Bank of Italy quarterly economic bulletin

Earnings from Charles Schwab and Bank of America

▶ **Google earnings:** The search engine makes its first quarterly report since announcing that co-founder Larry Page would take over as CEO. Analysts expect $6.3 billion in revenue.




**16**

Global Youth Service Day

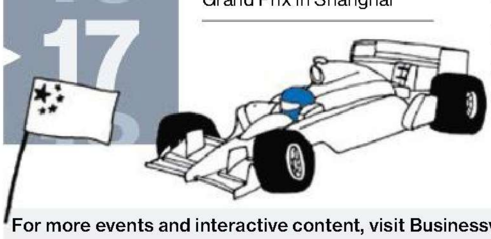


▶ **World Bank and IMF spring meetings:** Thousands of government officials and international bankers gather in Washington.



**17**

Formula 1: UBS Chinese Grand Prix in Shanghai



▶ **Elections in Finland:** The populist True Finns, who oppose the European Union and bailouts for member nations, have nearly 20 percent support in recent polls.

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# Organized Crime Goes to the Movies



## ▶ International gangs are cornering the market for pirated DVDs

## ▶ "This is relatively lucrative and not highly prosecuted"

The Jan. 10 murder of Gabriel Ayala Romero in a jail in northern Mexico could have been a scene out of *Scarface*, the 1983 Al Pacino film that details the life of a modern-day drug lord. Ayala Romero, known as Don Gabi, was stabbed more than 20 times in Topo Chico prison, where authorities say he was continuing to run a cell of the Los Zetas drug cartel. It wasn't drugs that landed him behind bars, though. Ayala Romero's role as head of Los Zetas's DVD and music piracy business had earned him a second nickname: the Czar of Piracy. Centered in northern and southeastern Mexico, the operation generated about $1.8 million a month, according to the Motion Picture Association of America. "He was murdered from within jail due to rival gang members, who were trying to gain control of his piracy organization," says Mike Robinson, the MPAA's chief of operations for content protection.

Lax enforcement and high profit margins have made trafficking in counterfeit DVDs a flourishing side business for drug smugglers and crime rings worldwide. Russian gangsters and Mexican drug cartels such as Los Zetas and La Familia Michoacana, Chinese gangs, and even former members of Northern Ireland's Irish Republican Army have all piled in to the lucrative business in the past decade, according to Robinson. "The scope of organized crime in home-video piracy is enormous," he says.




**Mexico's "Czar of Piracy" Ayala Romero was killed in prison in January**

Hollywood studios lose an estimated $6.1 billion annually to movie piracy, according to a report by the Institute for Policy Innovation. While the industry has used that loss estimate since 2005, faster Internet speeds have made it easier to transmit pirated movies online, further cutting into legitimate DVD sales. Consumers make 53 billion visits a year to websites selling pirated movies, TV shows, games, music, and software, according to a study by MarkMonitor, a company that ferrets out piracy websites for clients including **Time Warner**.

To combat its multinational adversaries, the MPAA is hiring former law enforcement officers outside the U.S., including in Russia, Singapore, Britain, and Malaysia, to improve cooperation with local police. In South Korea, piracy has cut so deeply into legal home-video sales that major studios have closed their regional home-entertainment offices because sales aren't high enough to support the operations, says Jeff Blake, head of film distribution for **Sony**. "There are titles we can't exploit beyond theatrical [release] because of piracy," Blake explains.

That hurts, since home video is Hollywood's most profitable business. By the time a movie is released in home-video formats—including DVD, Blu-ray, and video-on-demand—most of the production costs have been covered and the added cost of manufacturing disks and digital versions is negligible. Piracy is eroding these most lucrative sales at the same time the theatrical business is slumping. Box-office revenue is down 20 percent in the U.S. and Canada so far this year, according to Hollywood.com Box-Office. Sales of traditional DVDs in the U.S. are in long-term decline, falling 11 percent, to $14 billion, last year, according to the industry association Digital Entertainment Group.

Creating a counterfeit DVD is often a multi-step affair involving illicit recordings collected from multiple countries with audio and video pieced together to produce DVDs in various languages. Piracy rings typically either steal a digital copy of a film or secretly bring a camcorder into a theater in a country with lax enforcement such as Russia, Mexico, or Pakistan, according to Robinson.

In developed countries where theater operators aggressively search for cameras in auditoriums, audio is recorded by people working with foreign gangs. The audio is later synced

FROM LEFT: AGENCIA EL UNIVERSAL/NEWSCOM; FENG ZI/COLOR CHINA PHOTO/AP PHOTO



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# $6.1b

Hollywood's estimate of revenue lost annually from pirated movies




Shops like this one in southern China often sell counterfeit DVDs



with video recorded elsewhere to make copies that can be burned onto DVDs or distributed over the Internet, according to industry officials. The MPAA says some pirates have created rogue websites that look legitimate enough that they are able to sell advertising on them. Stolen movies are streamed from the sites for free; the pirates make money from the ads. The Justice Dept. last June seized the domain name and content of NinjaVideo.net, which the agency said had links to more than 200 movies and 300 TV shows, and sold ads and took donations from users.

The MPAA is lobbying for passage of legislation in the U.S. that would speed up the process for Justice to seize domain names of such sites and warn advertisers. For sites that charge a fee to watch pirated movies, the legislation would block credit-card payment. "The Internet has regrettably become a cash cow for the criminals and organized crime cartels who profit from digital piracy and counterfeit products," says Representative John Conyers Jr. (D-Mich.), ranking member of the House Judiciary Committee. "Millions of American jobs are at stake because of these crimes."

Gangs like the DVD trade because it's a high-margin business that also provides a means of laundering cash from other illegal enterprises, according to a 2009 RAND Corp. study. Drug cartels, with international distribution networks already in place, have found pirated movies an easy way to branch

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Ending Medicare as we know it? page 22 ▶




out. "If they've got the capacity and the networks to move stuff, then this is a natural," says RAND study co-author Gregory F. Treverton. "This is relatively lucrative and not highly prosecuted."

In Mexico, groups including Los Zetas burn copies of films onto DVDs and even stamp them with gang logos before they are sold in public markets, says Richard Halverson, an investigator with the National Intellectual Property Rights Coordination Center in Arlington, Va., a federal task force. The Center coordinates investigations and distributes information among agencies including U.S. Immigration and Customs Enforcement, the FBI, and Interpol.



Some pirated DVDs sold in Mexican markets sport gang logos

In addition to stepping up law enforcement, film and television studios are urging Washington to negotiate tougher trade agreements and are forging direct ties with foreign law enforcement agencies. The RAND study says China, one of the world's largest consumers of pirated DVDs, will likely crack down on movie counterfeiting as its own movie industry expands. In recent years the Chinese government has conducted large-scale raids on plants in Macau and on the mainland to shut down pirate DVD manufacturers. In one 2007 raid, authorities seized 1.79 million discs and 30 machines used to erase source-identification codes that would show where the DVDs were made, according to the MPAA.

In the operation that led to Ayala Romero's arrest, the Mexican army seized 1,180 disc burners and 3.14 million copies of movies and TV shows from 23 warehouses. Movie piracy in Mexico costs Hollywood about $590 million a year, figures Federico De La Garza, head of the MPAA's Mexico affiliate. His office is urging Mexican authorities to organize more raids like the one that netted Ayala Romero. "Our objective is to motivate the authorities to go after the large groups," De La Garza says. —*Michael White, with Nora Zimmett*

***The bottom line*** *Hollywood studios are losing billions annually to DVD piracy. International organized crime rings are the latest culprits.*

Trade

# U.S. Companies Rush to Fill Japan's Supply Gap

▶ **The quake hit makers of everything from fish meal to chemicals**

▶ **"I'm not trying to make money off of someone else's misfortune, but ..."**

After Japan's **Renesas Electronics**, the world's leading maker of chips used in car navigation systems, saw production capacity plummet due to Japan's Mar. 11 quake, Steve Sanghi, chief executive officer of Chandler (Ariz.)-based **Microchip Technology**, sent a letter to customers. He promised to ramp up chip production to fill the gap. He also had a tip for companies trying to line up microcontrollers: Buy now or pay more later. He warned of looming backlogs and recommended that customers line up at least 12 weeks' worth of chips in advance—far more than required during normal industry conditions. Advised Sanghi: "Those who commit backlog [orders] to us secure the supply first."

With many Japanese companies operating at reduced capacity, U.S. companies are racing to meet higher demand for everything from fish meal used in shrimp farming to caustic soda that goes into making soap and paper. "It's a wake-up call for companies about the risk of a global supply chain: 'Hello, now we have a huge disruption that's going to be very costly,'" says Clyde V. Prestowitz Jr., president of the Economic Strategy Institute, which promotes U.S.-based manufacturing. "Business is going to be good for guys who have maintained a presence in the U.S."

Beyond opportunities for companies such as **Caterpillar,** whose heavy equipment will be needed for Japan's rebuilding, lost Japanese production means a lot of supplier business is now up for grabs. In 2010, Japanese companies sold $120.3 billion worth of goods in the U.S., according to the Commerce Dept. Interest in U.S. food exports also is rising in Japan after the government there said on Mar. 26 that 99 products tested in Tokyo and five prefectures, including milk and vegetables, were found to be contaminated by radiation from the Fukushima Dai-Ichi nuclear plant. Shortages in Japan are boosting prices at **Hallmark Fisheries** in Charleston, Ore. Black cod fetches about $9.30 a pound, $1 more than last December, according to Production Manager Scott Adams. "I'm not trying to make money off of someone else's misfortune, but Japanese love their seafood," Adams says. "They are going to want fish they know is caught from a safe area."

**Tyson Foods**, the largest U.S. meat processor, saw a jump in Japanese demand after the quake, as well as requests to fill orders there more quickly, Chief Operating Officer Jim Lochner said on Mar. 30. **Smithfield Foods**, the world's largest pork processor, also has seen an uptick in Japanese demand for fresh pork, according to Chief Financial Officer Bo Manly. "To us, that's signaling they have very little meat at a retail level," Manly says.

Japan's nuclear reactor woes may also boost North American liquefied natural gas exports, as governments worldwide review their energy needs, says Steven

Japan's woes are spurring demand for a range of U.S. goods:




THIS PAGE, RYAN: J. SCOTT APPLEWHITE/AP PHOTO; PORK: THOMAS NORTHCUT/GETTY IMAGES; COD: BRIDGET BESAW/AURORA PHOTOS; BOTTLE: CREATIV STUDIO HEINEMANN/GETTY IMAGES; TRUCK: GODDARD AUTOMOTIVE/ALAMY; SOAP: AARON GRAUBART/GETTY IMAGES. OPPOSITE PAGE, SIMIONI: SCOTT LEWIS/BLOOMBERG; OJON BOTTLES: SCOTT LEWIS/BLOOMBERG



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The power of the ojon berry: from a Honduran rain forest to the shelves of Sephora

Farris, chairman and CEO of energy producer **Apache**. "Given the unfortunate circumstances ... that gas becomes more interesting to the market than it was probably three months ago," he told investors on Mar. 28.

With Japanese plants forced to idle up to a quarter of their capacity to produce paraxylene, which is used in plastic beverage bottles, and caustic soda, U.S. chemical producers such as **Dow Chemical** and **Occidental Petroleum** may benefit, says Mark Eramo, executive vice-president of consultant Chemical Market Associates in Houston. Says Hassan Ahmed, an analyst at Alembic Global Advisors in New York: "If you are a large producer not in Japan, you'll benefit from the pricing spike." —*Jeff Green, Shruti Date Singh, and Ian King*

***The bottom line*** *With plant closures and power cutbacks limiting production in earthquake-ravaged Japan, American suppliers could see new business.*

**Personal Care**

## Estée Lauder Tries a Hair Makeover

▶ **The cosmetics giant is revamping its Ojon rain forest line**

▶ **"Hair became increasingly important as a fashion item"**

In the late 1990s a relative from Central America gave Denis Simioni a baby-food jar filled with a brown gloop that seemed to restore luster to dry hair. Simioni, who owned a Toronto advertising agency focused on beauty products, began tinkering and researching the goo's provenance. He traced it to the Honduran rain forest where the Tawira Miskito Indians, or "people of the beautiful hair," had long harvested the ojon nut for its moisturizing properties. "I didn't know how it worked at the time, but I knew it worked and it was special," he says.

So special, in fact, that cosmetics maker **Estée Lauder** in 2007 plunked down $45 million for Simioni's Ojon brand of hair-care products. The acquisition so far hasn't added much extra body to the company's financial tresses: Sanford C.





Simioni

Bernstein analyst Ali Dibadj estimates that Ojon makes up only about 1 percent of Estée Lauder's $7.8 billion in sales. Last year, Estée Lauder took an $8.8 million charge for Ojon's "reformulation"—a sign the brand "has not performed well and is in need of the relaunch," says Vivienne Rudd, an analyst at Mintel International Group in London.

Still, Estée Lauder is sticking with the crew-cut Canadian entrepreneur and his rain forest recipe as a way to ramp up its expansion into the hair-care business. While Estée Lauder commands up to a quarter of the high-end skin and makeup market in the U.S., its hair products accounted for only a "sliver" of the upscale hair-care business, Dibadj says.

Last month the New York-based company relaunched Ojon with an in-store marketing campaign. Simioni has become a regular pitchman on the **QVC** shopping channel, regaling viewers with tales of his jungle treks in search of mane-enhancing ingredients. Philippe Warnery, an Estée Lauder vice-president who manages the Ojon brand, says its acquisition gave Estée Lauder not just a premium product but also a popular entrepreneur with a compelling story who can connect directly with customers. With the amiable former adman's QVC appearances, Estée Lauder can also track customer responses with an immediacy not easily found elsewhere, watching sales spike when he mentions key phrases—say, "repairs damage"—on air.

Estée Lauder, which entered the high-end hair market with its 1997 purchase of Aveda and also owns the Bumble and bumble hair-care brand, is focusing on so-called prestige hair-care products, a $7 billion global market. They typically sell for several times the price of mass-market shampoos and generate fatter margins. A two-ounce bottle of Ojon's Color Sustain conditioner, for example, sells for $9 at cosmetics chain **Sephora**.

Better yet, hair-care sales aren't particularly susceptible to stress in the economy, says Wendy Liebmann, chief executive officer of consulting firm WSL Strategic Retail. "After skin care, hair care is most durable in good times and bad," she says. Over the past decade, "hair became increasingly important as a fashion item and people were willing to spend a premium on it." Prestige hair-care sales grew by 8.8 percent, to $6.9 billion, in the five years through 2010, according to consumer researcher Euromonitor International.

Dibadj says Estée Lauder recently has taken steps to make the Ojon brand more mainstream by focusing on its scientific properties rather than its "folkloric" appeal. Estée Lauder's scientists have documented the effects of ojon oil and other ingredients, giving the marketing team ammunition to hype Ojon's restorative properties. One claim: that hair's condition improved 64 percent after just one application of its damage-reverse line. Store displays rolled out last month feature more ethnically diverse models to demonstrate the products' effectiveness on various hair types.

When he isn't pushing Ojon on TV, Simioni, 43, still travels in search of elixirs used by traditional communities for specific properties—Mexican blue agave for hydration or amaranth for protein—that Estée Lauder scientists can probe further. His next destination? Undecided. "Odds are, knowing us," he says, "it's remote."
—*Lauren Coleman-Lochner*

***The bottom line*** *Drawn by the economic resilience of hair-product sales, Estée Lauder is overhauling its Ojon brand of rain forest-inspired hair-care products.*





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## Companies&Industries

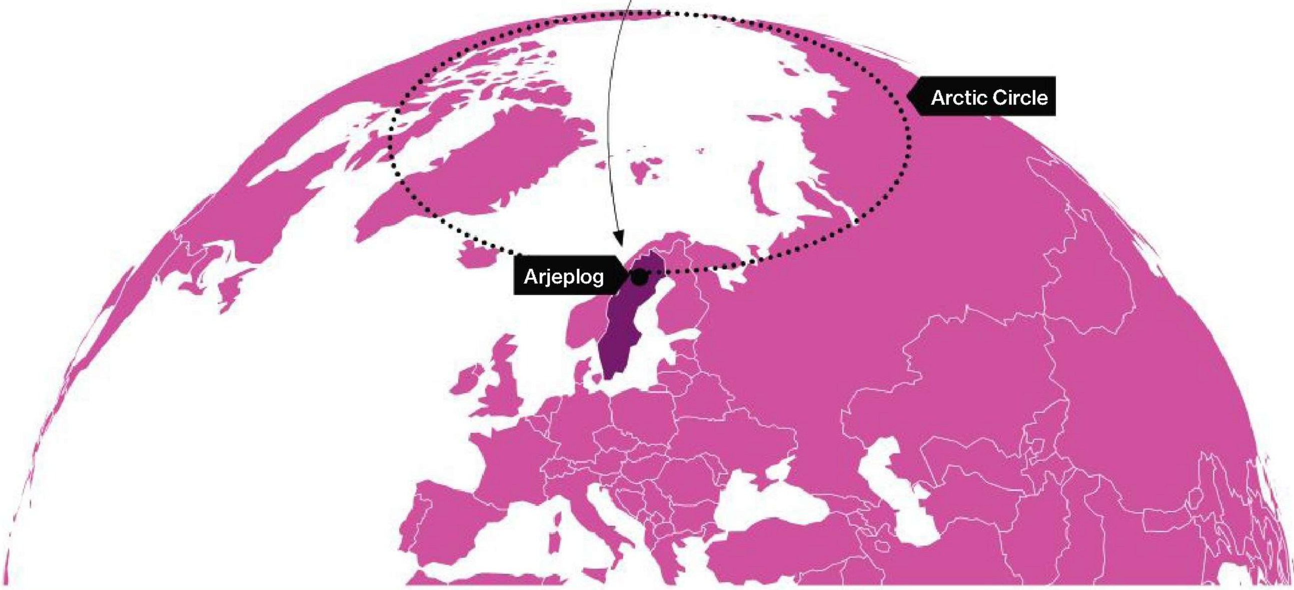


### Winter Wonderland

Sweden's Arjeplog region has drawn carmakers from around the world to test their vehicles under its harsh conditions.



| | |
|---|---|
| Average winter temperature (C) | **-5°** |
| Number of frozen lakes | **8,727** |
| Companies testing in the region | **at least 12** |






**Autos**

# In Sweden's Frigid North, Car Testing Is Hot

- **Putting roadsters through their paces keeps Arjeplog on the map**
- **Without auto testing, "we'd probably starve to death"**

The roar of the BMW breaks the silence of the frozen lake. The V8-powered M5 punches the glistening snow as its tires find their grip on the icy track. The driver, BMW chassis engineer Bernd Limmer, emerges wearing a thick jacket and a big smile. It's a common scene in Arjeplog, a region in northern Sweden that swells every winter with secretive engineers speaking German, French, English, Japanese, and Korean. **BMW**, the leading luxury carmaker, tests cars in this remote location 60 kilometers (38 miles) south of the Arctic Circle alongside **Daimler**'s Mercedes-Benz, **Volkswagen**'s Audi, **Toyota Motor**, **General Motors**, **Ford Motor**, **Fiat**, **Peugeot**, **Saab**, and **Hyundai Motor**.

While Arjeplog is increasingly important to carmakers eager to optimize their vehicles for driving in extreme weather, the auto industry is a lifesaver for Arjeplog's 3,161 residents. The area struggled after the lumber industry dwindled in the 1980s and the local lead mine closed in 2001. "The car testing industry is absolutely vital to us," says Britta Flinkfeldt Jansson, Arjeplog's mayor. "Without it we'd probably starve to death, like our neighboring municipalities."

The Arjeplog region, slightly bigger than Connecticut, has 8,727 lakes—that's 2.8 per resident—filled with water said to be clean enough to drink. The public bulletin boards carry ads for "moose safari." What has attracted the car industry since the early 1970s is the area's reliable chilliness. This winter, temperatures have hovered around -20C (-4F) most days, making ice on the local lakes consistently thick enough for driving. "The climate conditions are perfect, and when you drive around you don't meet many people—maybe some reindeer," says Wilhelm Cordes, manager of BMW's testing facility. About 180 engineers convened at the test center at one point this season to work on making cars more fuel-efficient in cold weather and to optimize their anti-spin function.

While Arjeplog is the world's largest winter testing area, rival locations include Ivalo, Finland; West Yellowstone, Mont.; Carson City, Nev.; and Millbrook, England. Francisco Carvalho, an analyst at IHS Automotive, says such tracks provide automakers with "the ultimate test for the little things they can't detect or predict in a lab."

Almost 9,000 car industry officials

THIS PAGE, TRACK: JOHAN FJELLSTROM/LILAB. OPPOSITE PAGE: BOEING: MATT NAGER/BLOOMBERG; FREEDOM GROUP: ALLIANT TECHSYSTEMS/BLOOMBERG NEWS; GOOGLE: TONY AVELAR/BLOOMBERG; ELECTRONIC ARTS, WOODS: LUCAS DAWSON/GETTY IMAGES; XBOX 360: TOY ALAN KING/ALAMY.

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visit Arjeplog each winter, with about 2,800 engineers working on any given day. They create about 500 local jobs, counted on an annual basis, and pump 700 million kronor ($110 million) into the region's economy, more than triple Arjeplog's entire municipal budget of 190 million kronor. Tjintokk, Arjeplog's biggest private employer, has one customer: Volkswagen. The company provides tracks, repair services, housing, and some 180 test drivers for Europe's No. 1 carmaker. Volkswagen last year extended the contract 12 years, says Tjintokk Chief Executive Officer Karl-Erik Soderberg.

Arjeplog traces its car testing history to 1973, when German auto parts maker **Robert Bosch** tested an antilock brake system and got permission to use a landing strip for planes on Lake Hornavan. Opel, Mercedes, Volkswagen, and Porsche were the first carmakers to join Bosch, which still fine-tunes ABS systems in the area.

Arjeplog's 760 hotel rooms aren't enough to host all visitors, so locals rent out their homes. Mayor Jansson says Bosch engineers used her house for three weeks this winter while the family stayed in their summer cottage. "Virtually every local citizen derives incomes from the auto industry," says Stefan Oscarsen, head of **Argentis**, a company that promotes the local economy. "I never hear anyone complaining about it."

Arjeplog stands out in a battered region. The proportion of people under 30 in Norrbotten County in Sweden's northernmost quarter dropped to one-third last year from half in 1968 as young people left for jobs and life in bigger cities, according to Statistics Sweden. While Arjeplog's population has dropped 50 percent since the 1960s, it has gained in the last three years.

The carmakers attract another group to Arjeplog: photographers trying to snap pictures of unreleased models that can be sold to car magazines. *Achtung Paparazzi* warns a sign on the security booth at BMW's fenced-in facility. "One time they staged a fake accident with warning blinkers and reflective vests to get the test cars to slow down," Anders Lindberg, a driver for Tjintokk, says. "You just call and warn your colleagues." —*Ola Kinnander*

***The bottom line** Sweden's Arjeplog region, just below the Arctic Circle, has become the cold weather testing site for more than a dozen automakers.*

# Briefs

by Caroline Winter

## Boeing
### More plane inspections ahead

The cracks that caused a Southwest Airlines jet to rip open midflight on Apr. 1 developed on the Boeing 737-300 much earlier than expected, according to Boeing. The planemaker says the metal fatigue wasn't forecast to occur until after 60,000 flights, while the Southwest jet had only flown 39,781. After the incident, Southwest inspected 79 of its 737s and grounded five found to have cracks. The U.S. Federal Aviation Administration is now requiring emergency inspections on all 737-300s, 737-400s, and 737-500s that have made more than 30,000 flights. Boeing built those planes before 2000, when the company improved the design of the world's most widely flown jet.




## Freedom Group
### Shelving plans for an IPO



Freedom Group, the firearms and ammunition company controlled by buyout firm Cerberus Capital Management, called off plans for an IPO. Madison (N.C.)-based Freedom filed for an IPO in October 2009, saying it would seek to raise as much as $200 million. Plans for the listing were shelved after the gunmaker experienced several setbacks, including a slower firearms market in 2010 and the September departure of CEO Theodore Torbeck. Freedom now may arrange a private placement instead.

## Google
### Another antitrust probe looms

The U.S. Federal Trade Commission, which handles consumer protection issues, is considering a broad antitrust investigation into Google's dominance of the Internet search industry, say two people familiar with the matter. Before proceeding, the FTC is awaiting a Justice Dept. decision on whether it will challenge Google's planned acquisition of ITA Software on the grounds that it will limit competition in the travel information search business. The state of Texas and the European Commission have already launched antitrust investigations into Google's practices.




## Electronic Arts
### Leveraging Augusta National's appeal

Electronic Arts on Mar. 29 introduced Tiger Woods PGA Tour 12: The Masters, a video game featuring Georgia's exclusive Augusta National Golf Club. Sales of Woods's previous namesake game dropped by almost two-thirds after he acknowledged having extramarital affairs. He hasn't won a tournament since November 2009. Yet Electronic Arts is banking on the appeal of Augusta National, which counts Warren Buffett and Bill Gates among its 300-plus members, to spur sales of the title.



## Honda Motor
### European production on hold



Honda Motor will halve production at its main European factory for seven weeks starting Apr. 11 to cope with a component shortage following the earthquake and tsunami in Japan. A total of 139,000 CR-V, Civic, and Jazz models for 30 markets rolled off the assembly line in Swindon, England, last year. Once the shortage is eliminated, Honda hopes to accelerate production at Swindon and make nearly as many vehicles this year. The plant's 3,000 employees will each accrue 105 "banked" hours to be completed after production resumes.

**On the Move**

**Vale Murilo Pinto de Oliveira Ferreira to be CEO • Wright Medical CEO Gary Henley resigns • Discover Financial Services R. Mark Graf named EVP, CFO, and chief accounting officer • Sprint Nextel Joseph Euteneuer to be CFO**



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# The Audacity of Paul Ryan

▶ His plan would privatize Medicare, cut taxes, and cap social spending

▶ "The Medicare gravy train has come to a halt"

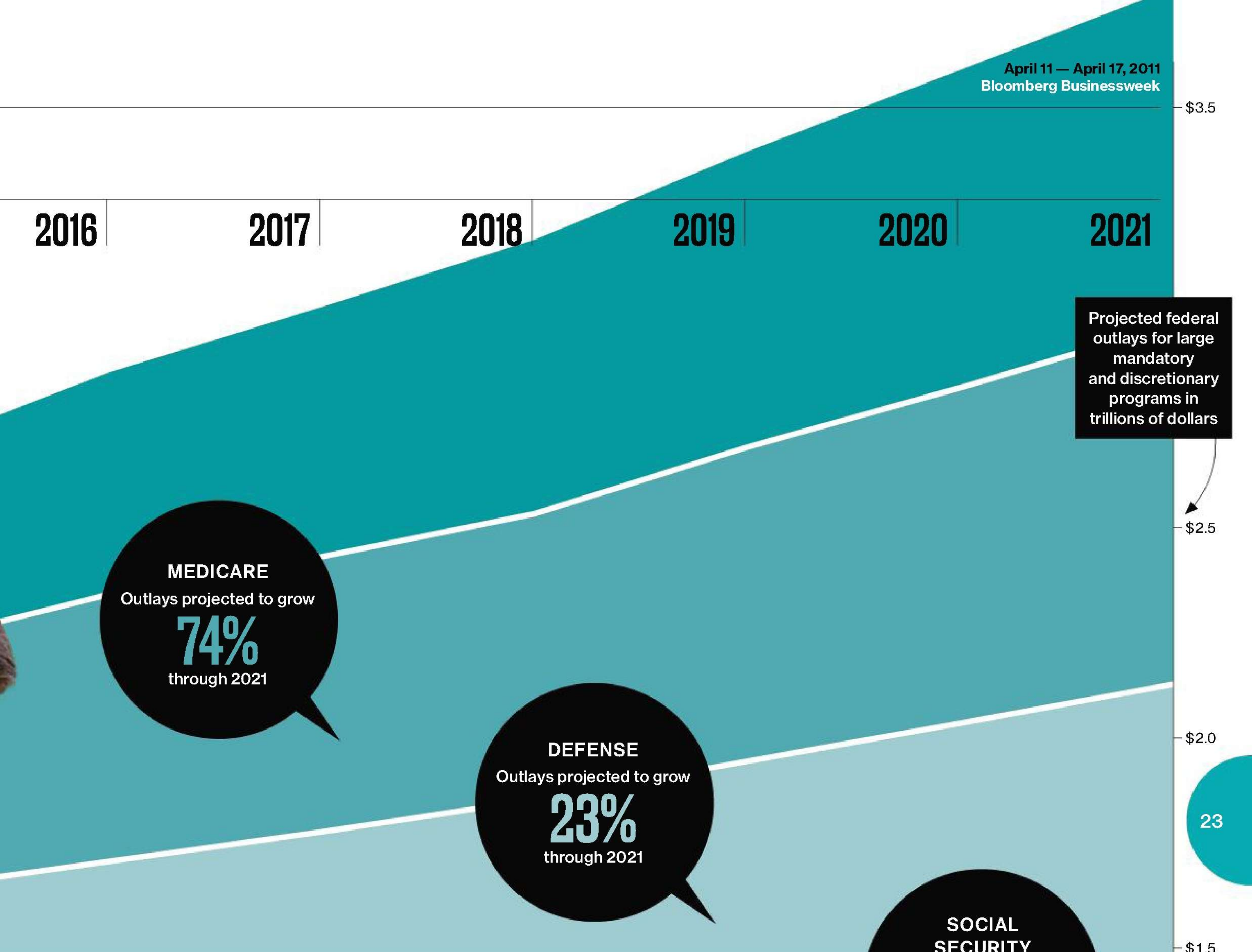
Paul Ryan, the House Budget Committee chairman, on Apr. 5 did something politicians seldom do: He stuck to principle. The fiscal conservative and Republican rising star stunned Washington with a 10-year budget blueprint that would shrink government, privatize the Medicare health program for seniors, turn Medicaid into a block grant to the states, and lower to 25 percent the top rate on corporate and individual taxes.

The plan would cut federal spending by $6 trillion over the next decade and slash the deficit to 2 percent of the economy by 2022, down from this year's 9 percent, without raising taxes. Among its weaknesses: overly optimistic assumptions, including that unemployment will be a mere 2.8 percent by 2021. By slashing money for food stamps, education, transportation, and scores of other programs, it's also politically untenable to Democrats. And despite the deep cuts, the House Republican plan would not balance the budget until 2040, largely because of offsetting tax cuts. Still, the scope of Ryan's proposal made Washington's nonstop bickering—and the threat of a government shutdown on Apr. 9 unless a deal is reached over funding levels for the next six months—seem small-bore by comparison.

Perhaps the biggest surprise is Ryan's call to convert Medicare, the $500 billion-a-year entitlement program and the biggest reason for mushrooming federal deficits, to a voucher-like system beginning in 2022. A week before Ryan presented his ideas, outside experts involved in the discussions said it was unclear whether the proposal would even cover Medicare. Along with Social Security,

Ryan

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Medicare is a crucial part of the social safety net, one that politicians historically have been loath to tamper with, including President Barack Obama in his 2012 budget.

Democrats could hardly contain their glee, believing they'd been handed their talking points for next year's Presidential election. Politically, at least, party leaders see Ryan's proposal as a replay of former President George W. Bush's abortive 2005 plan to create Social Security private accounts, which they used to rally seniors and regain control of Congress in 2006. Senator Debbie Stabenow (D-Mich.) calls Ryan's budget a "thinly veiled attempt to dismantle Medicare" that pulls "the rug out from under seniors."

Republican ambivalence was evident. The party's House leaders, while endorsing Ryan's spending plan generally, largely omitted any references to the Medicare overhaul. The plan is a calculated risk for the GOP. While the proposal could alienate senior citizens in swing states such as Pennsylvania, Florida, and Iowa, reining in spending may help win over independent voters who gave Obama the edge in 2008. Opinion polls show that independents, who represent 29 percent of the electorate compared with 16 percent for senior citizens, now consider the deficit the most pressing issue facing the nation after jobs. Ryan's budget "is not going to have the repercussions everybody thinks it will," says former Representative Tom Davis (R-Va.), who led the House Republicans' election efforts from 1998 to 2002. "A lot of it is going to be messaging," he says, and "the election is ultimately going to be about swing voters."

Republican leaders may be betting that by embracing the broader antispending message of Ryan's plan without dwelling on the details, they can show voters a road map to growth that depends in part on paring the debt and controlling runaway entitlements. "This is not simply a deficit-hawk dynamic," says Republican pollster David Winston, who advises House Speaker John Boehner (R-Ohio). "This is going back to Reagan and how you create jobs."

Ryan, 41, would essentially privatize Medicare by giving those over 65, beginning in the year 2022, about $8,000 to spend on private insurance that would replace the government program. Seniors would shop for subsidized coverage in an "exchange" where the government would approve insurance companies' offerings, says Conor Sweeney, a spokesman for Ryan. The plans would compete for seniors' business, and the subsidies would be based in part on income levels. The plan would also gradually raise the eligibility age to 67 by 2033.

DATA: CONGRESSIONAL BUDGET OFFICE; PHOTO: STEPHEN CROWLEY/THE NEW YORK TIMES/REDUX

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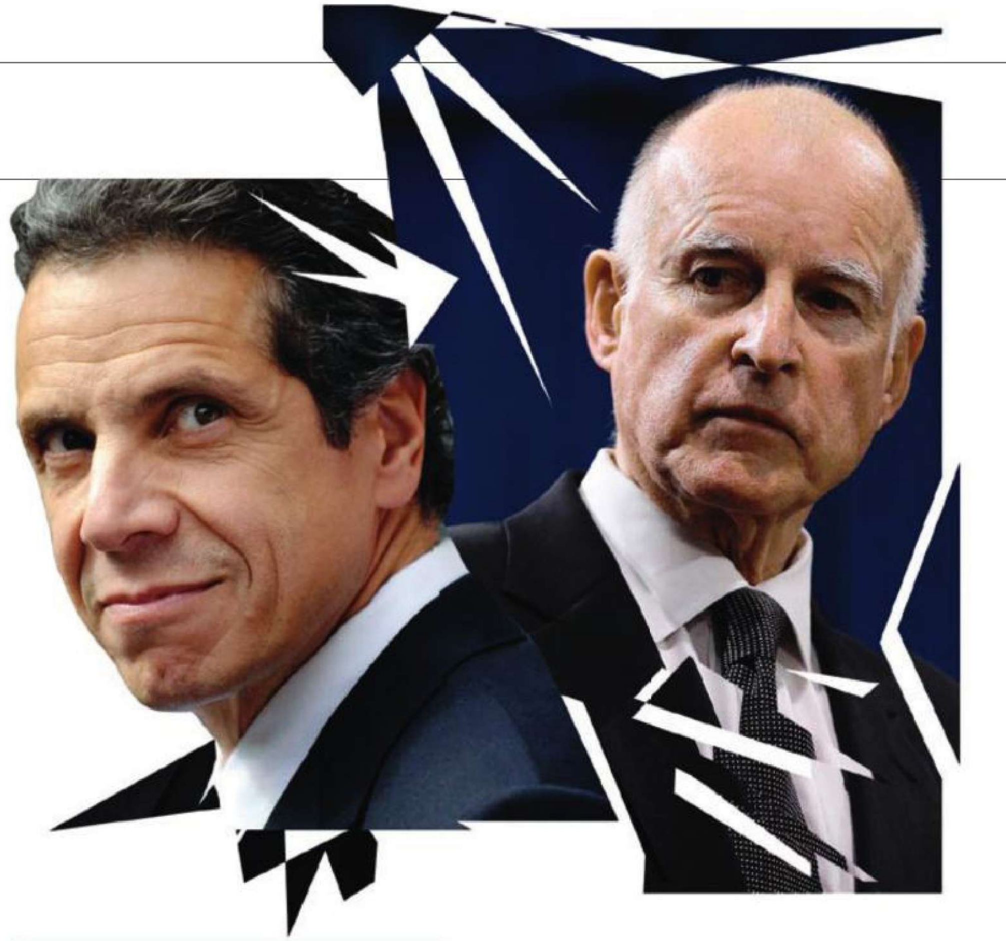
Economists Jonathan Gruber at the Massachusetts Institute of Technology and Uwe E. Reinhardt of Princeton say seniors would get less money to buy their coverage than under the current system. Ryan's plan would peg to the consumer price index the amount the elderly would receive to buy coverage. The CPI historically has grown more slowly than the cost of medical care. Gruber and others say any health-care plan that caps spending will end up rationing care and could leave people of modest means without adequate coverage. "Under the proposal, most elderly people would pay more for their health care than they would pay under the current Medicare system," the Congressional Budget Office said in an analysis. Joseph Antos, a health policy expert at the American Enterprise Institute who supports Ryan's proposal, says "the whole idea is to tell the health sector that the Medicare gravy train has come to a halt."

That's politically risky. In the midterm elections, Republicans used the threat of Medicare cuts under Obama's 2010 Affordable Care Act to oust Democratic incumbents. Republicans rode that message to a 21 percentage-point advantage among senior citizens. Ryan on Apr. 5 acknowledged the risk, but said reform couldn't wait. "We decided it is time to stand up and do what is necessary," he said. Republicans may hope to avert a baby boomer backlash by applying the plan only to those now under 55. "For people who are near retirement, security of what they have is very important to them," says Robert Blendon, a professor of public opinion and health care at Harvard University.

Ryan's prescription bears some resemblance to Obama's own health-care overhaul, says Gruber, who advised congressional Democrats when the law was being written. Pointing to several features of the Republican plan, including the call for a regulated market in which seniors could shop for subsidized coverage, Gruber says: "That's the Affordable Care Act." Considering that no Republican supported Obama's health plan and that Ryan's budget now calls for its repeal, that's the definition of audacious.

*—Heidi Przybyla and Drew Armstrong*

***The bottom line*** *Ryan's budget shifts the debate from domestic spending minutiae to entitlements. It also provides Democrats with short-term political ammo.*



CUOMO: RON ANTONELLI/NY DAILY NEWS VIA GETTY IMAGES; BROWN: JUSTIN SULLIVAN/GETTY IMAGES

State Deficits

## Cuomo vs. Brown: A Tale of Two Governors

▶ Budget success may rest on the power of the state executive

▶ "There are more institutional obstacles" for California governors

Jerry Brown and Andrew Cuomo are the kissing cousins of state government. Both Democrats are the sons of legendary former governors. Both were their state's attorney general and came to office this year vowing to get persistent budget deficits under control. So far, New York's Cuomo is succeeding; California's Brown is not.

The unique politics and culture of each state help explain why, but the better explanation may be institutional: Cuomo, with strong executive powers, was able to cajole his legislators into a deal. Brown, with less authority, threw up his hands in defeat.

California's weak executive model was on display on Mar. 29 when Brown was unable to persuade four Republican legislators to join him in calling for a special June election that would have let voters decide whether to extend existing sales, income, and vehicle taxes for five years. That left Brown with no clear path for closing a $15.4 billion deficit. With a June 30 deadline approaching and absent a budget, California again faces the humiliation of having to issue IOUs to pay some bills. By contrast, New York lawmakers from both parties on Mar. 31 approved a series of Cuomo-backed spending cuts in education and health care to eliminate a $10 billion deficit without raising taxes. They beat an Apr. 1 deadline for a new budget for the first time since 2006 and only the third time in the last 25 years.

California governors must contend with many more barriers than their New York counterparts, says Bruce Cain, a political science professor at University of California at Berkeley. Some are the result of decades of ballot initiatives that dictate how the government can raise and spend money, he says, including the 1988 proposition that locked in about 40 percent of general funds for education. The state also relies heavily on volatile sales and income taxes for revenue. "I don't think it's Jerry," Cain says. "There are more institutional obstacles that a California governor has to face."

California voters began ending the perennial legislative logjams in 2008 by stripping lawmakers of the power to



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draw their own legislative boundaries. Voters last year replaced conventional elections with a system in which the top two finishers in a primary, regardless of party, run against each other in the general election. Together the changes potentially make districts, and their representatives, less ideologically one-sided. In November, voters also lowered the two-thirds supermajority needed to adopt a budget to a simple majority, keeping the higher threshold for tax measures.

Still, the New York governor wields a larger stick than California's. Cuomo, 53, needs only a simple majority to raise taxes. He can also force lawmakers to choose between approving a budget and watching the government shut down. "In New York, they want a free lunch, but they realize it's not possible," says former California Governor Gray Davis, a native New Yorker who was recalled from office in 2003 over budget-deficit issues. "In California, not only do we want a free lunch, we think we have a constitutional right to it."

Cuomo's $132.5 billion blueprint cuts spending by 2 percent, the first decline in total outlays since at least 1995. He blocked fellow Democrats from extending an 8.97 percent millionaires' income tax, which they sought to prevent some of the deep cuts. Cuomo took on what he called "unsustainable growth" in school aid and Medicaid, the two biggest spending categories, persuading lawmakers to accept $5 billion of cuts. Legislative leaders say the process was speedier than in recent years because the tone of negotiations was more civil.

Brown, 73, had been negotiating with reform-minded Republicans who wanted to cap state spending, change public pensions, and ease business regulations. Talks broke down as both sides accused the other of intransigence. Senate Republican Leader Bob Dutton complained on Mar. 31 that he hadn't met with the governor until a week earlier, when Brown was accompanied by his wife, Anne Gust Brown, a lawyer and adviser. "Frankly, I was yelled at more than I was talked to," Dutton told reporters, "and mostly by Mrs. Brown."
*—Michael B. Marois, James Nash, and Michael Quint*

***The bottom line*** *As New York completes its first on-time budget in five years, California continues to struggle with a $15.4 billion deficit.*

Regulation

# Federal Rules Favor Too-Big-to-Fail Banks

▶ **Proposals on mortgages and derivatives entrench large banks**

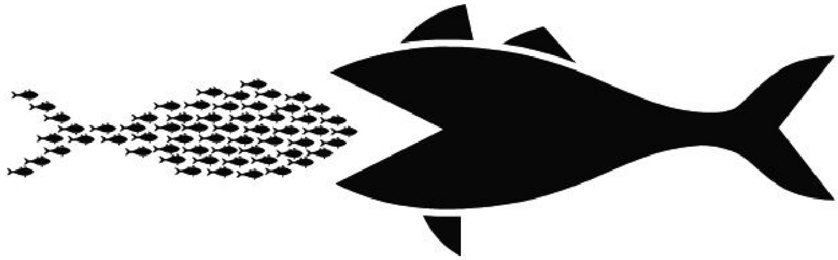
▶ **Big banks "want to do everything they can" to control the market**

As lawmakers debated how to overhaul financial regulations, their mantra was that, if nothing else, the era of "too big to fail" was over. Never again would taxpayers have to rescue the largest banks to stop them from capsizing the entire financial system. By the time the Dodd-Frank financial reform law was signed in mid-2010, 10 banks controlled three-quarters of all banking assets, up from 68 percent in 2006, in part because big banks had scooped up troubled institutions. "Very large, systemically significant institutions were at the heart of the crisis," says David A. Moss, a Harvard Business School professor.

So it's all the more surprising that federal agencies putting the reforms into force are writing rules that strengthen the dominant position of the biggest banks. The Federal Reserve, for example, issued regulations meant to curb commission payments that gave mortgage brokers an incentive to steer homeowners to risky mortgages, but those rules could also make it easier for large banks to dominate the mortgage market. During the housing bubble, brokers often earned more by selling high-cost loans, even if borrowers qualified for lower rates. The rules now in effect require loan officers to be paid a salary and prohibit commissions tied to a loan's interest rate. No doubt regulations are needed to protect home buyers from unscrupulous practices, but the Fed's rules could deliver a fatal blow to mortgage brokers, who help homeowners shop for mortgages among different lenders. Like stockbrokers, they earn most of their compensation through sales volume, not salaries. Brokers increasingly have been spurned by big retail banks, which rely on branches and building salaried sales forces, says Guy Cecala, publisher of the trade paper *Inside Mortgage Finance*.

The same big-bank bias is built into rules proposed by six agencies in late March that would require issuers of mortgage-backed securities to keep 5 percent of the bonds on their books. The hope is that, by holding a share of the risk, banks will limit shoddy lending. Conservative mortgages—for borrowers with good credit and at least 20 percent down—would be exempt. Larger banks can afford to keep the required risk on their books, while "community banks don't have the wherewithal on their balance sheet and the ability to raise the additional capital that would be necessary," says Karen M. Thomas, head of government relations for the Independent Community Bankers of America. **Wells Fargo**, which originated a quarter of all residential mortgages last year, lobbied for even more conservative requirements, saying only those with 30 percent down should be exempt from the rules. "They view it as a competitive advantage to have large and deep pockets," Cecala says.

Derivatives rules also favor big institutions over small. The market is already highly concentrated, with the trading desks of five large players executing 96 percent of swaps by commercial banks. The big players "want to do everything they can do to control the post-Dodd-Frank market," says Michael Greenberger, a law professor at the University of Maryland and a former Commodity Futures Trading Commission official. The act requires traders to post collateral and process most derivatives through clearinghouses. It's an open question, though, whether





WorldMags

Minecraft, the indie video game page 32 ▶



Willis



regulators will prevent large banks from controlling the clearinghouses. In the fall, the CFTC proposed letting dominant players own up to 5 percent of clearinghouses without any cap on their collective ownership. The Justice Dept. said the lack of an aggregate limit "will not sufficiently reduce the risk that major dealers may control" the exchanges and block out smaller players. Rules favoring big banks may not be a problem if regulators are "exceedingly tough" in overseeing the risks that giant institutions take on, says Harvard's Moss, but those rules too are still up for grabs. —*Karen Weise*

***The bottom line*** *The Dodd-Frank financial reform law was supposed to end "too big to fail," but its implementation could make big banks even bigger.*

Employment

# The Gender Gap in Government Job Cuts

▶ Females make up the majority of state and local union workers

▶ "They are taking a wrecking ball" to female-dominated professions

During the 18-month recession that ended in June 2009, men lost far more jobs than women. But since the recovery began, the tables have turned and women have fared worse, largely because of public sector cutbacks. As governors continue to trim spending to balance budgets, more layoffs are on the way, and women-dominated fields such as teaching, nursing, and home health care are vulnerable.

In the rancorous debate over government jobs, pensions, and collective bargaining, the disproportionate effect on women has gone almost unnoticed. Women lost 72 percent of 378,000 government posts cut between July 2009 and March 2010, according to the Labor Dept. When private sector gains are included, women had a net loss of 212,000 jobs between July 2009 and last month.

Men added 757,000 jobs, mostly in the private sector, in that same period, though they continue to lag behind women in overall job gains. The male workforce is 6.8 percent below its pre-recession employment level, while women remain 3.7 percent behind.

Now as the private sector ramps up, the public sector–and local government especially–continues to shed jobs. This year will be "the toughest year yet for local governments," Moody's Investors Service said in a Mar. 16 report. Local government has the highest concentration of female workers of the three government levels, at 62 percent. Females hold 57 percent of all government jobs, Labor Dept. data show.

Some of the biggest hits are in public education. Women made up about 76 percent of teachers in the 2007-08 school year, the latest available figures from the Education Dept. New Jersey Governor Chris Christie has cut school aid by $1.3 billion since taking office in January 2010. Eighty percent of the state's districts reported teacher reductions this school year, says Frank Belluscio, a spokesman at the New Jersey School Boards Assn. Ohio Governor John Kasich's spending plan would cut 7,000 teachers over two years, says Innovation Ohio, which lobbies for the poor and middle class. Government is "taking a wrecking ball to what have traditionally been female-dominated professions," says Randi Weingarten, president of the American Federation of Teachers. Dawn Willis, 39, is among those who have lost jobs because of budget cuts. She was a social studies teacher in Jackson, N.J. "I find it hard to believe we're in a recovery," she says. After eight years of classroom experience, she may switch careers. "I've always been very optimistic, but now I'm starting to swing the other way."

Diana Furchtgott-Roth, a senior fellow at the Hudson Institute, a Washington research group that advocates limits on labor power, says the laws curbing union bargaining will allow fewer dismissals and limit tax increases, saving states money. "The current system is unsustainable," says Furchtgott-Roth, who was chief economist at the Labor Dept. under President George W. Bush. "Women are the winners in all this."

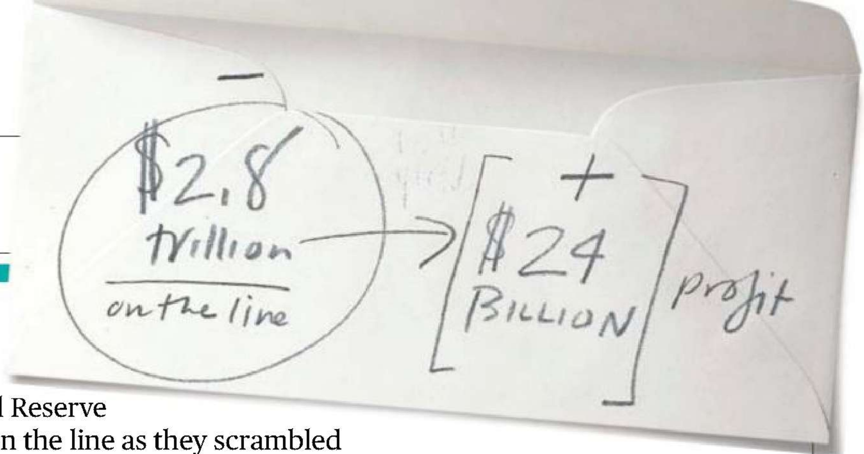
That's hard to square with the data: Last month, Michigan Governor Rick Snyder stripped bargaining rights from home-based child-care workers, 94 percent of whom are female. The widely publicized law championed by Wisconsin Governor Scott Walker, which is being challenged in court, would revoke bargaining rights for university hospital workers, home health aides, and day-care providers. Firefighters and police, overwhelmingly male, are exempt. Limiting collective bargaining could also jeopardize flexible work hours and maternity leave, says Joan Entmacher, a vice-president of the National Women's Law Center, as well as widen the gender wage gap. In 2010, female union members earned 89¢ for every dollar male counterparts earned, according to the Labor Dept. Non-union women made 81¢ on the dollar. Ⓑ —*Esmé E. Deprez and Holly Rosenkrantz*

***The bottom line*** *Public sector job losses have fallen disproportionately on women, as states cut female-dominated jobs in education and health care.*

PHOTOGRAPH BY MICHAEL SCHMELLING FOR BLOOMBERG BUSINESSWEEK



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Back of the Envelope

# Accounting for the Bailout

At the height of the financial crisis, the Federal Reserve and the Treasury had more than $2.8 trillion on the line as they scrambled to prevent a financial meltdown. The government's total exposure was an even higher $23.7 trillion–if the U.S. were forced to make good on all promises, including guaranteeing Fannie Mae and Freddie Mac, says the special inspector general for the Troubled Asset Relief Program. The rescue efforts are now on track to turn a profit of about $24 billion, according to Treasury's Mar. 30 projections. —*Rebecca Christie*

## Troubled Asset Relief Program

**COMMITTED:** $700 BN

**BOTTOM LINE:** $28.1 BN LOSS

The $700 billion Troubled Asset Relief Program was the primary bailout vehicle for both the Bush and Obama Administrations. Treasury expects bank capital injections to turn a profit once the government exits all bank investments. It projects losses to come from housing and auto industry assistance.

### BANKS

Treasury injected $245 BN into about 700 banks. Already it has collected $251 BN from repayments, dividends, and warrant sales. Combined with two smaller bank programs, Treasury is on track to reap a $19.7 BN PROFIT including $12 BN from Citigroup and $1.4 BN from Goldman Sachs Group.

### AIG

Insurance giant American International Group got Fed and Treasury bailouts of $182 BN

Of that, about $68 BN came from TARP, and that portion is expected to generate an $8 BN LOSS

Treasury also got $20 BN worth of AIG stock—based on the shares' Nov. 30, 2010, market value—from the Fed as part of a December restructuring that boosted Treasury's ownership stake to 92% from 79.9 percent. Treasury says the U.S. may come out about $12 billion ahead once it sells those shares.

### AUTOS

Treasury put about $82 BN into General Motors, Chrysler, and both their financing arms and suppliers. It projects a $14.8 BN LOSS

### HOUSING

Treasury has set aside $45.6 BN to help distressed homeowners stay in their homes and doesn't expect to get any of that back.

### CREDIT MARKETS

Direct purchases of troubled assets from banks' frozen balance sheets—TARP's original intent—turned out to be minor. Still, Treasury expects a $500 MN gain on the Public-Private Investment Program and similar efforts.

## Federal Reserve Programs

**COMMITTED:** $1.7 TN

**BOTTOM LINE:** $110 BN PROFIT

The Fed's wide array of programs to prop up the financial system will generate $110 billion for taxpayers, Treasury says. The programs include Fannie Mae and Freddie Mac debt purchases, a commercial paper funding facility, purchases of asset-backed bonds, dollar swaps with other central banks, and the AIG bailout.

## Mortgage-Backed Security Purchases

**COMMITTED:** $225 BN

**BOTTOM LINE:** $13.5 BN PROFIT

Treasury purchased mortgage-backed securities in 2008 and 2009. It expects to sell them over the next year at a profit.

## Money-Market Mutual Funds

**COMMITTED:** $50 BN

**BOTTOM LINE:** $1.2 BN PROFIT

After investors began fleeing money-market mutual funds, regulators scrambled to backstop the $3.3 trillion industry. Treasury committed $50 billion to a government insurance program that collected $1.2 billion in premiums. It never had to cover any losses.

## Fannie Mae and Freddie Mac

**COMMITTED:** $154 BN

**BOTTOM LINE:** $73 BN LOSS

Fannie and Freddie are operating with an unlimited federal government lifeline. So far they have received about $154 billion and paid about $20 billion in dividends, for a net drawdown of $134 billion.

## Federal Deposit Insurance Corp.

The FDIC guaranteed $350 billion in corporate debt and $834.5 billion in business checking accounts through programs that Treasury projects will break even. The FDIC is now running a surplus, with $10 billion in premiums offsetting $2.4 billion in claims to date. -0-

DATA: U.S. TREASURY



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# Technology

# The Law Firm Techies Like to Friend

▶ **Silicon Valley's Fenwick & West is raking it in during the social-networking boom**

▶ **"I'm in that tribe," says one attorney of his affinity with geeks. "Those are my people"**

Gordon "Gordy" Davidson is one of Silicon Valley's top *consiglieri*. In a career spanning almost four decades, the lawyer has helped Cisco raise venture capital, steered Intuit and eBay through their initial public offerings, and helped VeriSign with its $17 billion acquisition of Network Solutions in 2000—still the largest Internet deal ever. He's seen technological waves come and go over the years. The latest, social networks and online media, is a doozy, and his law firm, Fenwick & West, is riding the trend like no other firm in the Valley. "Silicon Valley came out of a recession faster than the rest of the country, and we saw it coming a little bit sooner than our peers," says Davidson, who became chairman of the firm in 1995. "Financially, times are very good."

Unlike larger local rivals such as Wilson Sonsini Goodrich & Rosati and Cooley, Fenwick specializes in startups. Its clients are some of the biggest names on the Internet—Facebook, Twitter, and rising stars such as home-rental site Airbnb and cloud-storage company Dropbox. The firm will almost certainly help Facebook through the IPO process, according to a person familiar with the firm's and the company's plans, which could happen early in 2012. Fenwick "is one of the great indigenous firms of Silicon Valley," says Larry Kramer, dean of Stanford Law School. "It understands how the Valley works better than most, everything from how to raise money, where to incorporate, and how to nurture and grow a startup."

Fenwick was founded in 1972 in

**Growth area: Helping startups deal with secondary markets, where nonpublic shares trade**

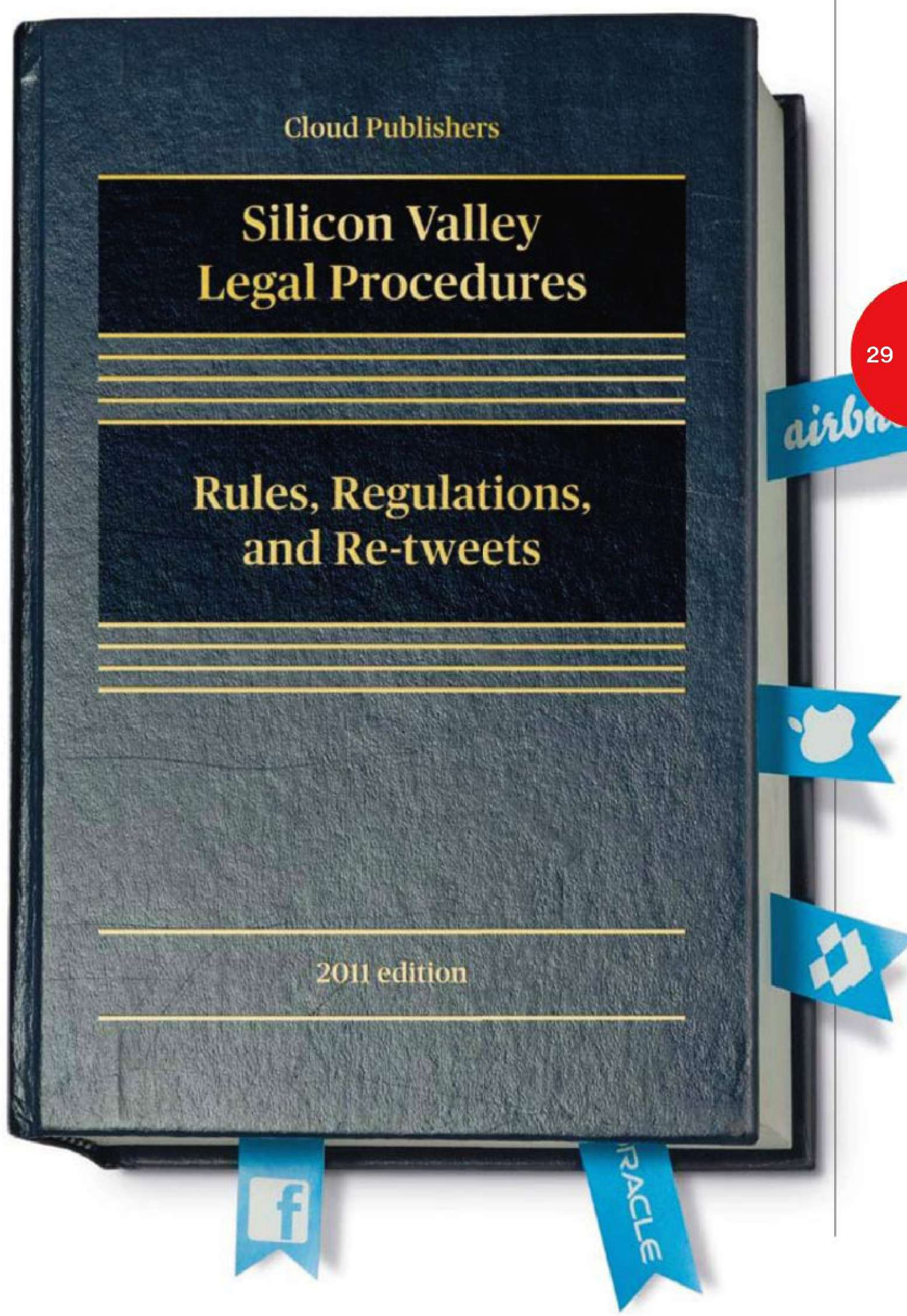



ILLUSTRATION BY SHAWN HASTO



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# Technology

the same Palo Alto office building that then housed the older Wilson Sonsini. Fenwick's lawyers made their bones incorporating Apple and taking Oracle public. In 2002 the firm moved to its own six-floor office building in downtown Mountain View, Calif., about two miles from the Googleplex, and has kept its focus on young tech companies. Wilson Sonsini, which has more attorneys than Fenwick (377 vs. 253), has shifted in recent years from startups to more established heavyweights such as Hewlett-Packard, Netflix, Pixar, and Autodesk. Establishment firms grudgingly acknowledge Fenwick's rise. Sort of. "Given the growth of the tech industry, there's room for a good competitor, as we can't represent everybody," says Larry W. Sonsini, Wilson Sonsini's chairman.

Davidson dismisses that jab as playful rivalry. He can afford to: Revenues rose 8 percent in 2010, after dipping during the recession. As is common for Valley law firms, Fenwick sometimes takes an equity stake in companies it represents–Electronic Arts and Symantec, to name a couple. (It does not own Facebook equity, according to a person with knowledge of the matter.)

One of Fenwick's biggest draws is partner Ted G. Wang, a New Jersey transplant who joined the firm five years ago, and who surprised Davidson early on by having an avatar in the online virtual world Second Life. "I'm in that tribe," says Wang, 41, of his geek affinity. "Those are my people." Wang was the original outside corporate counsel for Facebook and now serves in that capacity for Twitter. When the two companies started competing more directly, he passed Facebook work on to his colleagues. Of that transfer, Davidson says, "It was just a question of Ted's time and personal relationships. There's never been a direct conflict."

**8%**

Amount Fenwick & West's revenue grew in 2010

Amit Kapur, a veteran of Myspace, was looking for a lawyer two years ago when starting his Santa Monica (Calif.) ad-targeting company, Gravity. He went with Fenwick, he says, because he was impressed with Wang's experience and advisory role at two of the Web's highest-profile startups. "We aspire to be a company of that size, and we want to have people around us that can guide us to do that," Kapur says.

Fenwick has experimented with ways to cut breaks on fees for startups. Last year, in a program called SeriesSeed, the firm put a half dozen standardized legal documents on the Web for free to help entrepreneurs streamline the process of funding their startups without generating big legal bills. Sutha Kamal, co-founder of mobile-health-information startup Massive Health, used the documents in January to close an infusion of $2.5 million in seed capital. "We got the round closed very quickly and saved money as well," he says, estimating the documents reduced legal expenditures from over $50,000 to $20,000. In another program started last year, called Flex by Fenwick, the firm offers clients who are not ready to hire a full-time attorney access to its network of contract lawyers who do low-cost legal tasks. Fenwick vets the lawyers and covers their overhead costs, such as malpractice insurance. Whatever those programs cost the firm in hourly billings they say is made up in goodwill (and far bigger fees later) should the client turn out to be the next Google.

**The Joy of Tech™**

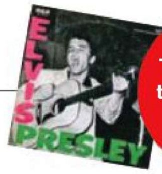



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The King in a takeover play
page 39 ▶

A growth area for Fenwick: helping startups figure out how to deal with the rise of so-called secondary markets, where buyers and sellers trade shares in nonpublic companies. One of the sites, SharesPost, has Facebook valued at $50 billion-plus. Davidson says secondary sales are a potential regulatory nightmare that raises "novel questions." For lawyers, of course, "novel questions" are another way of saying that, financially, times are very good.
*—Brad Stone with Serena Saitto*

***The bottom line** Fenwick & West, retained by Facebook and Twitter, is reaping the benefits from its long-standing focus on startups.*

Tablets

## IPad Causes Collateral Damage in Taiwan

▶ Acer's CEO resigns amid slow PC sales and a delayed start in tablets

▶ "Everyone is waiting" for Google's newest Android operating system

Taiwanese companies followed a simple strategy to get to the top of the global electronics industry: When all else fails, cut prices. During the depths of the financial crisis, for instance, Taiwan's **Acer** and **Asustek Computer** undercut their bigger stateside rivals by focusing on small, inexpensive laptops known as netbooks. By early 2010, Asustek had become the world's No. 5 PC maker, measured by shipments. Acer shoved aside **Dell** to reach second place, and executives at the Taipei-based company said it was only a matter of time before they passed **Hewlett-Packard** to become the biggest computer manufacturer in the world.

Now, all else really has failed. Acer revised its sales forecast downward in October and then again in March. On Mar. 31, Chief Executive Gianfranco Lanci suddenly resigned; the company said he'd disagreed with other board members over strategy. Why the change of fortune? Steve Jobs and the iPad, which went on sale in April 2010. Low-end machines from Taiwan couldn't match the appeal of **Apple**'s tablet, which cost about the same. Global laptop sales, which had been rising by double-digit rates before the iPad, collapsed; they grew just 1 percent in the first quarter of 2011. The post-P.C. era began last year, and Taiwan got blindsided.

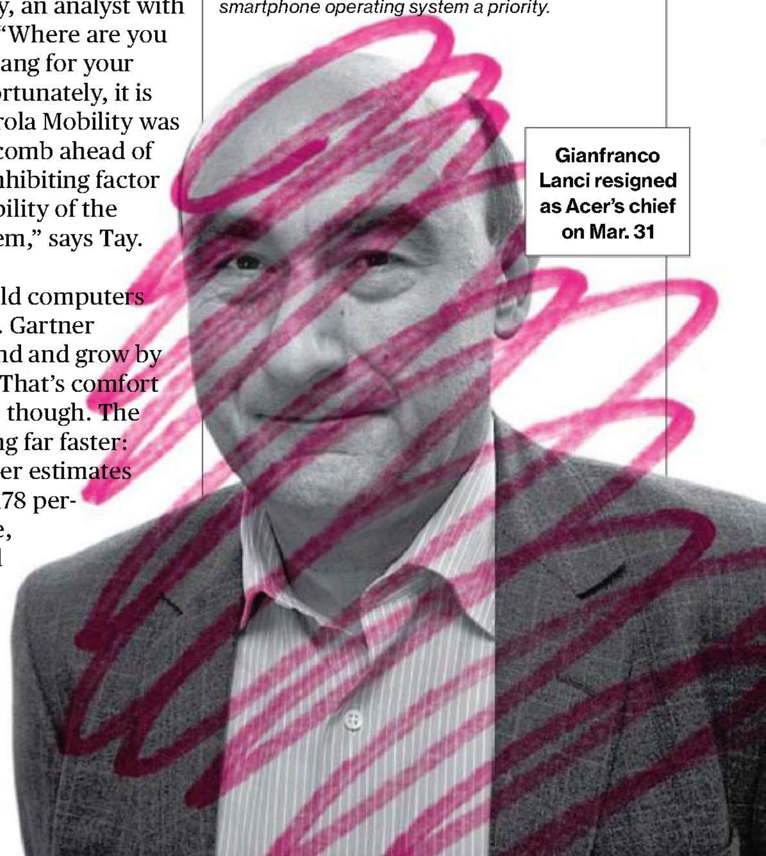
Companies there are only now coming out with tablets of their own. Acer says it will launch several tablets soon, and Asustek has begun accepting orders for its Eee Pad Transformer tablet. Both contenders are more than a year behind Apple. "It's not about having the products out there, because everybody else in the industry also has products out there," says Bryan Ma, a Singapore-based analyst with IDC. The question is, "How do you have that cool factor?"

In the PC era, the Taiwanese could count on cooperation from **Microsoft** and **Intel**, which provided early access to chip design changes and operating system upgrades. In the tablet era, it's more complicated. Microsoft and others are developing tablet operating systems, but Google is farthest along. Acer and Asustek plan to use Android, the search company's operating system for mobile devices, in their upcoming tablets. But the tablet-specific version, code-named Honeycomb, is taking longer than expected because Google has been focused on smartphones, according to Lillian Tay, an analyst with Gartner in Singapore. "Where are you going to get the most bang for your buck?" she says. "Unfortunately, it is now in phones." Motorola Mobility was given access to Honeycomb ahead of the Taiwanese. "The inhibiting factor right now is the availability of the correct operating system," says Tay. "Everyone is waiting."

Demand for plain-old computers is hardly disappearing. Gartner expects sales to rebound and grow by 10.5 percent this year. That's comfort only in the short-term, though. The tablet market is growing far faster: Research firm eMarketer estimates tablet sales will climb 178 percent in 2011, and Apple, with its head start, will maintain a 74 percent market share even in the face of increased competition.

To make up for lost time, Acer and Asustek may fall back on the strategy that worked so well with personal computers: Undermine the competition with lower prices. Yet Apple, never known for inexpensive products, has priced the iPad so aggressively that the tablet has actually become a low-cost option. "Apple wants to gain share as quickly as they can so nobody else can come in and make money," says Kirk Yang, managing director with Barclays Capital in Hong Kong. "That's just killed everybody." As the Taiwanese are learning, in the iPad era, the old price-cutting playbook needs an update.
*—Bruce Einhorn with Rishaad Salamat*

***The bottom line** Acer and Asustek have gotten a slow start in tablets in part because Google has made its smartphone operating system a priority.*



Gianfranco Lanci resigned as Acer's chief on Mar. 31

## Quoted

**"We have disappointed our investors and we have confused our employees. Bottom line, we have lost some of the credibility that is foundational to Cisco's success—and we must earn it back."**
—Cisco Systems CEO John Chambers in a 1,500-word memo to employees vowing better performance after four consecutive quarters of disappointing earnings





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## Technology

Video Games

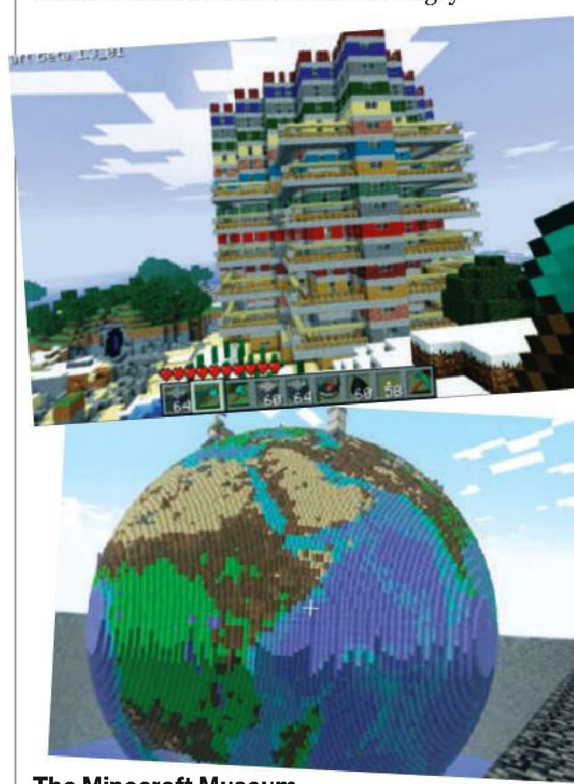
# The Improbable Rise Of Minecraft

▶ The free-form Lego-like game has sold more than 1.75 million copies

▶ "It starts to transcend the idea that this is purely an 'indie' success"

When Markus Persson was a teenager, a teacher asked him to think about his future. He responded with a jokey list "of things I wanted to accomplish before I was 30," he says. "The last couple of items were, 'Work as a game developer' and 'Become a millionaire.'"

He's a year late, but he can now put check marks alongside both. Persson, 31, is the lone developer behind Minecraft, a no-frills video game that has sold more than 1.75 million copies. If it hasn't quite reached the status of major hits such as Call of Duty: Modern Warfare 2, which has sold 14 million copies since its 2009 release, it also hasn't spent a dime on marketing. And unlike iPhone bestsellers such as Angry



**The Minecraft Museum**
Minecraft is a "sandbox" game—players can explore and build at will. Many share their creations on sites like minecraftmuseum.net

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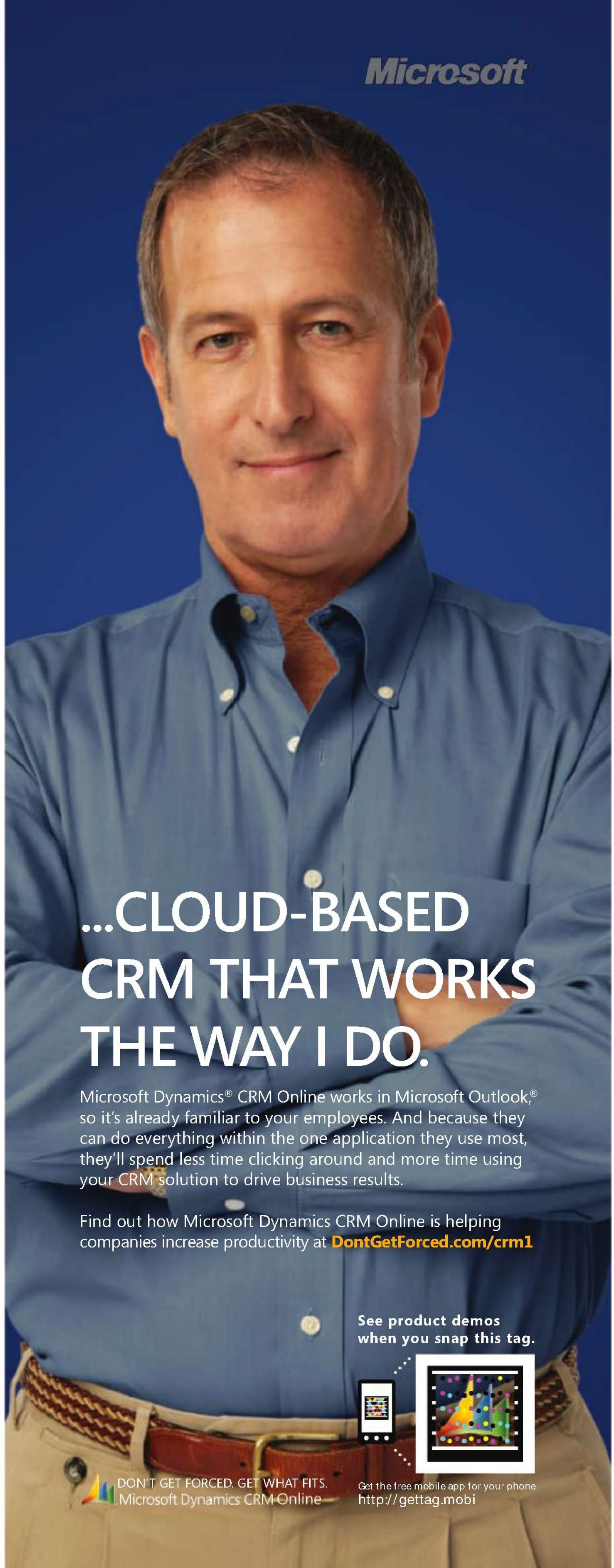
Birds, Persson's game hasn't enjoyed the distribution might of **Apple** or any other company.

The only place to buy Minecraft is on Persson's website, where it goes for €15 ($21). The game is played through a Web browser and puts users inside a vast, pixelated landscape. The goal, as much as there is one, is to avoid being eaten by monsters that come out after dark. But all the fun lies in building elaborate edifices to protect against those bumps in the night. Players use square blocks of materials like dirt, gravel, and clay to construct caves, towers, and fortresses. It's like playing with digital Legos.

That simplicity appeals to fans who use the game's building blocks to create art. One user designed a microprocessor within the game; flip a few switches, and it solves simple equations (1.35 million views on YouTube). Another built the exoskeleton of *Star Trek*'s *U.S.S. Enterprise* and invited other players to help flesh out the interior (3.44 million views). The fans' devotion is so intense that the studio producing the Minecraft documentary was able to raise



Clockwise, from top left: Part of one player's cityscape; a Minecraft version of the *U.S.S. Enterprise* from *Star Trek*; a typical Minecraft landscape; the globe rendered in blocks




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# Innovator

# Jennifer Pahlka



The former conference organizer is bringing software coders and cash-strapped cities together to give government services a boost

Firefighters and computer programmers don't often interact. Yet in February, representatives of both gathered in Boston's City Hall, where fire department officials explained one of their wintertime worries: snowbound fire hydrants. The coders quickly responded with a website that mapped every hydrant in the city and encouraged residents to "adopt" each one and take responsibility for shoveling them out after snowstorms.

The site is a product of Code for America, founded by Jennifer Pahlka in September 2009. She modeled the organization after Teach for America, with the goal of uniting technologists and city employees. In October, CFA selected 20 fellows, who received a modest stipend ($35,000), moved to San Francisco, and committed to a year of public service. The first class spent February talking to more than 400 city officials and residents in Boston, Philadelphia, Seattle, and Washington, D.C. The participants have returned to San Francisco, where they're writing software to tackle the civic challenges they learned about during the trip. One group's first project is a program that uses GPS data to let parents and students in Boston check whether school buses are running late.

All the software is open-source, says Pahlka. That means it's free for anyone to adopt, so if Bostonians find school-bus tracking useful, Seattle can implement it, too. The plan is to create a library of "civic software" that municipalities can draw on, helping them avoid spending money on projects that replicate others' work. That's particularly important in a time of budget crises, which are "breaking the backs of the cities," says Pahlka. "This is a new model" for saving them money.

CFA is not just about software but about pulling more technologists into public service, says Tim O'Reilly, a technology book publisher and CFA board member. "There are thousands of Silicon Valley startups doing the kind of work that the CFA fellows are doing," O'Reilly says. "There are not thousands of them doing it in the sphere of government services."

Pahlka has always been interested in public service. After graduating from Yale University, she worked at two Bay Area nonprofits, including a child welfare agency, but found them too rigid and bureaucratic. She left for the world of tech media, where she spent 15 years running conferences, including the Game Developers Conference and Web 2.0 Summit. She conceived the idea for a nonprofit corps of programmers in 2009 while organizing the first Gov 2.0 Summit, a conference focused on how technology can improve civic life. She says it "felt like an opportunity to do what I'd originally set out to do, but in a much more dynamic environment." —*John Tozzi*

**Career** ▶ **Graduated from Yale; spent 15 years organizing tech conferences**

**Program** ▶ **Code for America gives $35,000 to 20 technologists each year**

**Output** ▶ **Open-source "civic software" to help solve municipal problems**

## Technology

$210,000 from more than 3,000 contributors to make the feature film.

Persson coded Minecraft on a lark in 2009, looking for a side project when he came home from working his day job at King.com, a gaming site. By the end of January he was selling about 7,000 copies on an average day. "Once it got up to 15 copies a day, that was enough for me to have a salary. After that it's been like imaginary numbers," Persson says. The Independent Games Festival awarded its grand prize to Minecraft in March, though the game has done so well in the marketplace that "it starts to transcend the idea that this is purely an 'indie' success," says Brandon Boyer, IGF's chairman.

In late 2010, Persson founded a new gaming company in Stockholm called **Mojang** ("gadget" in Swedish). He and seven employees split their time between continuing development of Minecraft and working on a new video game, Scrolls, which Persson says will be a mix between the classic board game Risk and the fantasy card game Magic: The Gathering.

**7,000**

**Copies of Minecraft sold on an average day. The game goes for €15**

Minecraft follows in the tradition of other indie-game hits such as Crayon Physics Deluxe, which asks players to maneuver a ball by drawing ramps and other objects. Before deciding to sell the game on his own, Crayon creator Petri Purho talked to a publishing company about a marketing and distribution deal. "The money was very little that they offered, and on top of that they wanted to own basically everything about the game," Purho says.

Yet there are advantages to having a partner. Mojang plans to create versions of Minecraft for iPhones, iPads, and Android phones that will be available later this year and make use of third-party app stores such as Apple's iTunes. That might make Minecraft a little less "indie"–and potentially a much bigger hit.

—*Chadwick Matlin*

***The bottom line*** *Indie Minecraft sells 7,000 copies a day, enabling its developer to hire employees and expand the game to mobile phones and tablets.*

PHOTOGRAPH BY GABRIELA HASBUN FOR BLOOMBERG BUSINESSWEEK



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Contents ▶ The European bank that feasted on Fed funds 38 ▶ Alec Gores bids for *American Idol* 39 ▶ AllianceBernstein's performance problem 40 ▶ Record earnings may keep the stock rally going 41 ▶ Bid & Ask 42 ▶ Charlie Rose talks to Barclays' Bob Diamond 43 ● Edited by Eric Gelman



# Japan's Debate: How to Fund the Cleanup

▶ **The central bank faces pressure to underwrite new government debt for reconstruction**

▶ **Direct bond purchases would "spur sharp inflation and yield a big blow to people's lives"**

When politicians in Tokyo start talking about Depression-era monetary policies, it's clearly not business as usual in the Japanese Diet. Rebuilding quake-destroyed homes, roads, and ports, not to mention cleaning up radiation leaks from the still-crippled Fukushima Dai-Ichi nuclear plant, will require a 20 trillion yen ($235 billion) reconstruction package, say lawmakers from Prime Minister Naoto Kan's Democratic Party of Japan and the opposition Liberal Democratic Party. The trick is how best to fund it without crippling a Japanese economy that even before the earthquake had been coping with deflation, weak domestic demand, and the world's biggest government debt load.

That's why Bank of Japan Governor Masaaki Shirakawa, the country's guardian of sound money since 2008, has one of the toughest jobs in central banking right now. He's resisting a proposal submitted by a group of ruling party legislators to Finance Minister Yoshihiko Noda on Mar. 18 calling for the BOJ to buy government debt directly, according to a blog posting by DPJ member Yoichi Kaneko. The group claims this radical policy worked in the 1930s. "Bank of Japan bond underwriting is a policy that is evaluated highly worldwide because it helped Japan recover from the Great Depression before others," the Kaneko group's proposal says. These lawmakers also support a 20 trillion yen special reconstruction budget, which the Diet will consider in coming weeks.

In the early 1930s, then-Finance Minister Korekiyo Takahashi instructed the Bank of Japan to buy bonds issued by the government. The BOJ effectively ment eager to spend. Takahashi boosted spending by 34 percent in the 1932 fiscal year, financing it by doubling bond issuance, according to a report by the Japan Center for Economic Research. While the effort helped end deflation, much of the outlays were used for the military, and Takahashi made enemies when he later attempted to rein in inflation by tightening credit. He was slain in 1936 during an attempted military coup.

Using a central bank's power to print money as a means to finance deficit spending, a technique known as monetizing debt, is controversial. Shirakawa, 61, has repeatedly shot down the idea. "If a central bank starts to underwrite government bonds, there may be no problems at first, but it would lead to a limitless expansion of currency issuance, spur sharp inflation, and yield a big blow to people's lives" and the economy, as has happened in the past, he said in a Mar. 22 appearance in the Diet.

**Japan may need to finance a $235 billion reconstruction program at a time when its government debt load is already the highest in the world**

He also told lawmakers the Japanese bond market is deep enough to absorb more bond issuance without seriously driving up yields.

Even critics of Shirakawa, who has spent most of his career at the central bank, admire his intellect. Koichi Hamada, a Yale University economics professor who taught Shirakawa at the University of Tokyo in the early 1970s, describes him as a "brilliant student, very cool and objective with a critical spirit." Shirakawa also earned a master's in economics at the University of Chicago. Hamada thinks the BOJ should finance at least a portion of the reconstruction program with direct bond purchases, given the multiple economic hits to Japan this year. "This is a matter of a rather big emergency," says Hamada. He also thinks the BOJ and Finance Ministry should

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continue intervening in the currency market to push the value of the yen down to 100 to the dollar, from about 85 now, to help exporters.

Deflation, not inflation, is the country's biggest immediate worry. Consumer prices excluding fresh food fell for the 24th straight month in February, by 0.3 percent from a year earlier. Japan's gross domestic product contracted at a 1.3 percent annualized pace in the fourth quarter, and Morgan Stanley MUFG Securities predicts it may shrink as much as 12 percent in the April-to-June quarter. Japan's outstanding government debt is about 200 percent of economic output.

**200%**

Ratio of public debt to Japan's gross domestic product

Given these numbers, some lawmakers are reluctant to raise taxes to pay for reconstruction efforts. "There's no way that taxes can be increased when there's deflation," said Kozo Yamamoto, a Diet member with the opposition LDP, in a recent interview. Yet some sort of tax hike is a possibility if the BOJ doesn't underwrite some of the reconstruction bond financing.

Shirakawa can point to the record 15 trillion yen the BOJ pumped into the Japanese banking system three days after the Mar. 11 quake, and the doubling to 10 trillion yen of an existing plan that includes the purchase of corporate and even some government bonds on the secondary market. The BOJ is also considering offering temporary loans to banks to aid companies with cash-flow problems.

The debate in Japan parallels discussions last year in the U.S. and Europe, when the Federal Reserve and European Central Bank adopted government bond-buying programs to boost economic recoveries from the 2008-09 global financial crisis. The Fed and ECB bought bonds on the secondary market, not straight from government issuers.



Shirakawa is under intense pressure from lawmakers

So why is Shirakawa so opposed to direct purchases of bonds from the government when the BOJ buys them from banks and insurers in the secondary market? It's one thing to conduct bond purchases to manage money supply or ease tight credit conditions; it's quite another to use such purchases to bankroll government deficit spending, in the eyes of bond traders. "If central bank purchases are viewed as financing of government expenditure ... bond yields will also increase, reflecting rising inflation expectations," said Shirakawa in a speech he gave to Japanese monetary economists last September, according to the transcript.

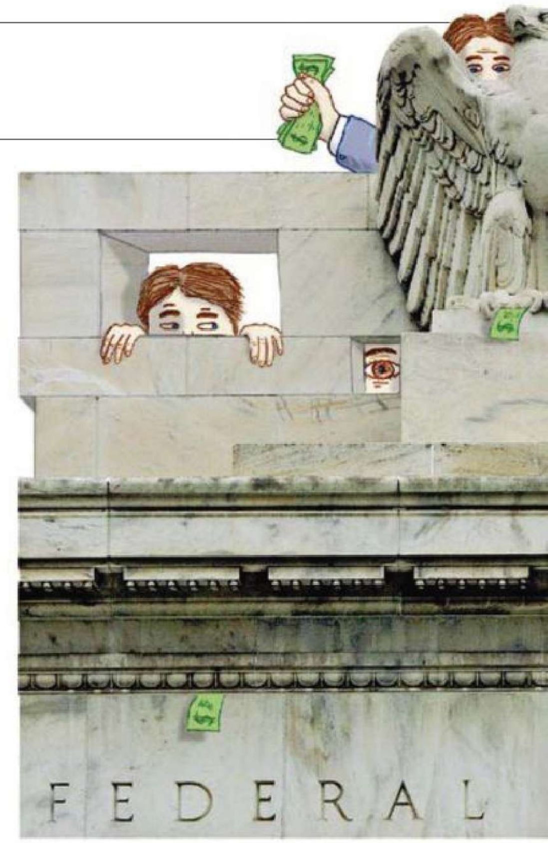
Some sort of tax increase could be part of the combination of options to fund Japan's earthquake cleanup, according to Michael Auslin, director of Japan studies with the American Enterprise Institute in Washington. "You see a lot of social solidarity in Japan right now to recover," says Auslin. "A tax increase might actually be politically palatable." Shinichiro Furumoto, the director general of the DPJ's tax committee, has floated the idea of a 1 percentage point increase in Japan's 5 percent consumption tax.

Even if the current policy debate over how to fund the earthquake recovery is resolved in coming weeks, Shirakawa and the BOJ will continue to face criticism in the Diet over the country's poor economic performance, deflation woes, and economic stagnation over the past two decades. Last fall some 150 Democratic Party lawmakers who call themselves the anti-deflation league proposed that the Bank of Japan adopt an inflation target to eradicate price declines and bolster employment, even if that means adjusting the central bank's current charter, which gives the BOJ a great deal of independence from government meddling.

Yale University's Hamada says the BOJ's priorities need to be redirected. "The Japanese economy has done very poorly," he says, "not only compared with developed economies, but developing ones like South Korea."

*—Brian Bremner, Toru Fujioka, Takashi Hirokawa, and Mayumi Otsuma*

***The bottom line*** *The BOJ's credibility is at stake as it resists efforts to underwrite Japanese bonds to fund $235 billion in quake cleanup costs.*




Bailouts

## Why a Foreign Bank Feasted on Fed Funds

- Europe's Dexia played a critical role in the U.S. muni bond market
- Its bankruptcy "could have been a catastrophe for municipal finance"

The biggest recipient of funds from the Federal Reserve discount window during the financial crisis was a European bank that received a total of about $300 billion in loans, guarantees, and cash infusions from governments and central banks. It also owned a subsidiary implicated in a bid-rigging scheme that prosecutors say defrauded U.S. taxpayers. According to details of Fed lending released on Mar. 31, **Dexia**, based in Brussels and Paris, borrowed as much as $37 billion, with an average daily loan amount of $12.3 billion in the 18 months after Lehman Brothers collapsed in September 2008.

By aiding Dexia, the Fed kept money flowing into local government projects throughout the U.S. Dexia guaranteed bonds issued by entities as varied as the Texas Veterans Land Board in Austin and the Los Angeles County Metropolitan Transportation Authority. The big-

SHIRAKAWA: HARUYOSHI YAMAGUCHI/BLOOMBERG; FED: WIN MCNAMEE/GETTY IMAGES; ILLUSTRATION BY LEIF PARSONS



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gest buyers of those bonds were money market mutual funds.

If Dexia had gone "bankrupt, it could have been a catastrophe for municipal finance and money funds," says Matt Fabian, a senior analyst and managing director at Municipal Market Advisors in Concord, Mass. "The market has extensive exposure to foreign banks."

Overseas banks accounted for about 70 percent of discount window loans when borrowing reached its peak of $113.7 billion in October 2008, according to the Fed's data. The discount window, established in 1914, is known as the lender of last resort. By law, most U.S. branches of foreign banks have access to the discount window, says David Skidmore, a Fed spokesman.

The Fed has kept discount window borrowers secret for 97 years. Last week's disclosures were court-mandated after legal victories by **Bloomberg LP**, the parent of *Bloomberg Businessweek*, and **News Corp.**'s Fox News Network.

Dexia, which borrowed $37 billion from the discount window in January 2009, said its loans from central banks peaked at $165 billion in October 2008. That month, it obtained up to $202 billion in debt guarantees from France, Belgium, and Luxembourg, of which the bank tapped a maximum of about $130 billion in May 2009. The countries and existing shareholders also provided Dexia with about $8.4 billion in capital.

The Fed loans have been repaid, according to Ulrike Pommée, a Brussels-based Dexia spokeswoman. Dexia used the Fed's emergency lending facilities to finance U.S. assets only, she says, adding that the bank was one of the biggest backstops of municipal bonds, providing letters of credit or so-called standby bond-purchase agreements–guarantees to buy the bonds if investors redeemed their stakes.

Over most of the last decade, thousands of cities, counties, hospitals, and universities issued long-term floating-rate bonds and paired them with interest-rate swaps to try to protect against higher borrowing costs. The strategy, which relied on banks such as Dexia to guarantee a market for the variable-rate notes, collapsed when investment firms and bond insurers lost their top credit ratings. Demands to back up muni bonds sapped Dexia so much that it was "two days from bankruptcy," Pommée says.

Interest-rate swaps have cost U.S. taxpayers billions. The Denver public school system is looking to borrow $800 million to escape a wrong-way bet on rates because Dexia is declining to renew its credit protection later this month. Pittsburgh and Detroit also have had to restructure debt after Dexia decided not to renew their insurance.

Dexia's lifeline from U.S. taxpayers came as federal officials were investigating allegations that two subsidiaries colluded with others to defraud state and local governments. The Dexia units were among more than a dozen financial firms that conspired to pay below-market interest rates to state and local governments on guaranteed investment contracts, or GICs, according to documents filed in a U.S. Justice Dept. criminal antitrust case against another company, CDR Financial Products. Municipalities buy GICs with money raised by selling bonds, allowing them to earn a return until the funds are needed for schools, roads, and other public works. CDR has denied wrongdoing.





Dexia's Financial Security Assurance division, which has not been indicted, said in February 2008 that its bond insurance unit had received a Wells notice from the Securities and Exchange Commission indicating that the agency plans to recommend legal action in connection with the GIC investigation. While Dexia sold FSA's bond insurance unit, it has said it remains exposed to legal risks because it kept another division of the company. —*Bob Ivry*

***The bottom line*** *Fed documents show Europe's Dexia borrowed up to $37 billion in U.S. loans. Some argue it was urgent to keep the bank afloat.*



Private Equity

## The Man Trying to Buy *American Idol*

▶ Alec Gores made his fortune turning around tech orphans

▶ "I don't make vanity deals," says the private equity investor

For the past two decades Alec Gores has thrived by acquiring companies–usually mid-size tech businesses–improving their operations, and selling them at a profit. Now Gores is striking out in a different direction. On Mar. 23, The Gores Group, his private equity firm, made an unsolicited offer for **CKX**, the company that controls the rights to *American Idol*, according to a person with knowledge of the bid.

Sitting in his 18th-story office in the Westwood section of Los Angeles, Gores, 58, won't discuss the CKX bid. He does say that the skills he has developed turning around technology companies can be applied to other industries. "We know how to restructure a

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company, how to make companies operate better," he says. Gores, who raised $2 billion for new investments two months ago, says he also has his eye on a well-known fashion company, which he will not name.

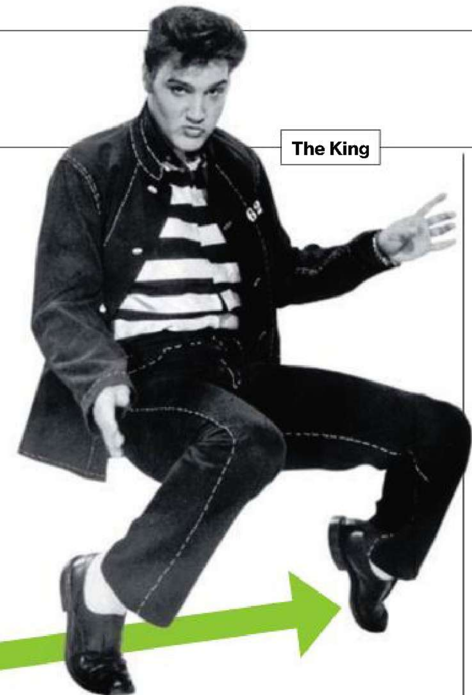
CKX isn't his first foray outside tech. Gores paid $100 million for a majority stake in radio syndicator **Westwood One** in 2008. Last year he teamed up with his 46-year-old brother Tom, who runs his own private equity firm, **Platinum Equity**, on an unsuccessful bid for movie studio **Miramax**, producer of *Shakespeare in Love*. A third brother, Sam, 56, who owns **Paradigm**, a talent agency in Beverly Hills, provided advice on that bid. Gores Group made its first investment in the fashion business last year, buying a stake in **J. Mendel**, the maker of furs sold by high-end retailers, for an undisclosed price.

An Israeli-born Christian, Gores moved with his family to Flint, Mich., when he was 15. Working three jobs, he put himself through Western Michigan University, graduating with a degree in computer science. He began customizing software for friends, family members, and other clients, eventually building a company that he sold for $2 million in 1986. With that stake he launched his private equity career, founding Gores Group, then known as Gores Technology Group, in 1987. His first targets were small companies that Gores says he restructured by instituting some of the practices he had learned from his software clients.

The Gores "model," as he describes it, is to buy "orphan" divisions from large companies that don't want to



*American Idol* judges Steven Tyler and Randy Jackson



The King

devote the time or resources to fixing them—then quickly streamline operations, usually with layoffs and other cost-cutting measures. He describes his approach as low risk. "I don't make vanity deals," he says.

In 2007, Gores paid $100 million for a unit of **Tyco Electronics** that makes power supplies for computers and other equipment. He brought in new managers, cut prices on some products by improving the supply chain, and stepped up customer service. Within 18 months, the on-time delivery rate at the company, now named Lineage Power Holdings, went to 90 percent from 50 percent. In January, Gores sold Lineage to **General Electric** for $520 million.

Over the past 25 years, Gores has sold 32 companies, with participants in his funds earning 4.4 times their investment from the deals, he says. Including unrealized gains, his funds rank in the top 25 percent of private equity funds tracked by Preqin, a research firm based in London. Gores Group currently owns 70 companies worth a combined $4 billion.

Just because he's chasing after Steven Tyler and Randy Jackson doesn't mean Gores has lost his taste for tech. Gores Group and Platinum Equity are trying to buy a majority stake in telecom-equipment maker **Nokia Siemens Networks**, according to people with knowledge of the Gores' intentions. If the bid succeeds, Gores would combine the company with Siemens Enterprise Communications, which he bought in 2008. **TPG** is also bidding for Nokia Siemens, according to the same people. "We stated last summer that we've been approached by a handful of potential investors," says Nokia Siemens spokesman Ben Roome. "We don't have any update."

CKX, which also controls **Elvis Presley Enterprises**, owner of the rights to the singer's name, image, and likeness, rebuffed takeover offers last year, including one from former CEO Robert F.X. Sillerman. CKX did not respond to requests for comment. If Gores succeeds, his knack for turning companies around will face a new test. "Entertainment and fashion are higher-risk industries as consumers' tastes are harder to figure out," says Steve Kaplan, a professor of finance and private equity at the Chicago Booth School of Business. "But some billionaires can't resist the attraction of the limelight." —*Serena Saitto and Ronald Grover*

***The bottom line*** *Gores, who has recently raised $2 billion for deals, is broadening his reach from tech to fashion, retail, and media.*

Money Managers

## AllianceBernstein Can't Stop the Bleeding

- CEO Kraus has shuffled personnel and launched new products
- "Some people are saying they will wait for the proof"

Since joining investment manager **AllianceBernstein** as chairman and chief executive officer in December 2008, Peter Kraus has worked diligently to stem client defections. He recruited money managers, tied compensation more closely to stock performance, and rolled out new products in areas such as inflation protection and asset allocation. The measures haven't worked so far.

Clients, mainly institutions, pulled $126 billion from the company's funds in 2009 and 2010. That's 28 percent of assets and represents the highest withdrawal rate for any publicly traded U.S. mutual-fund manager during the same period. In February, AllianceBernstein ranked last among 23 rivals in an institutional investor brand-loyalty survey by Cogent Research, a research and consulting firm in Cambridge, Mass. "Their clients are walking out the door, and a lot of institutional investors don't have

CLOCKWISE FROM BOTTOM LEFT: ALBERTO E. RODRIGUEZ/GETTY IMAGES; FRANK DRIGGS COLLECTION/GETTY IMAGES; MCT/NEWSCOM



WorldMags

A threat to high-speed rail? page 62 ▶






a positive impression of them," says Christy White, a principal at Cogent. "It doesn't bode well."

When Alliance Capital Management acquired Sanford C. Bernstein in 2000, the $3.5 billion deal combined Alliance's focus on investing in fast-growing companies with Bernstein's specialty in stocks its managers deemed undervalued. Bernstein also ran a highly regarded investment-research unit. The combined firm's assets peaked at $837 billion in 2007, and have since tumbled 42 percent, to $487 billion, as of Feb. 28.

Kraus, 58, blames the withdrawals on "poor" stockpicking in 2008 and what he called "episodic and volatile" performance in some of the firm's equity funds over the past two years. AllianceBernstein's equity funds trailed 67 percent of peers in the three years ended Feb. 28, data from Lipper show, a period that includes most of 2008, when the MSCI All Country World Index fell 42 percent. For the past year, the funds beat 51 percent of rivals. "I see no reason why our returns in the future won't be consistent and better than the competition," Kraus says in an interview at the company's midtown Manhattan headquarters. "I also understand why some people are saying they will wait for the proof."

The firm suffered dearly from its exposure to financial stocks that collapsed in the second half of 2008, according to Katie Rushkewicz, an analyst for Morningstar. AllianceBernstein Global Value had 29 percent of its assets in the sector, including **Fannie Mae**, **American International Group**, and **Citigroup**, on May 31, 2008, regulatory filings show. The fund lost 52 percent that year, more than 91 percent of peers, according to data compiled by Bloomberg.

The firm's relative returns will improve as 2008 results drop out of three-year performance numbers, Kraus says. "I don't think our clients believe we have become somehow mentally incapacitated or that we are not good stockpickers," he says.

Among the investors that have pulled money from AllianceBernstein are New York state's pension system and Vanguard Group, the largest U.S. mutual-fund manager, which uses the firm to help manage some of its funds. At the end of February, 57 percent of AllianceBernstein's assets were from institutions, 27 percent from retail investors, and the rest from high-net-worth individuals, according to a Mar. 10 statement.

Like AllianceBernstein, **Janus Capital Group** and **Legg Mason** have struggled to limit redemptions. Legg Mason had outflows of $179 billion in 2009 and 2010, equal to 26 percent of its assets at the end of 2008. Janus had outflows of $9.9 billion, or 8 percent.

Kraus, a former Merrill Lynch executive, has put his stamp on the firm's lineup of money managers. Last year he promoted Sharon Fay, a 20-year company veteran, to chief investment officer of equities, hired Laurent Saltiel from Janus to manage international large-cap stocks, and brought in Ashish Shah from **Barclays Capital**, to be co-head of global credit investment. "Peter Kraus is turning the franchise around," says Macrae Sykes, an analyst at **Gabelli & Co.** Gamco Asset Management, Gabelli's money-management arm, and Gabelli Funds own 831,000 AllianceBernstein shares, data compiled by Bloomberg show.

AllianceBernstein is majority-owned by France's **Axa**, which continues to back Kraus, who got restricted stock worth $52 million at the time he was hired. "We are pleased with the steps Peter is taking to position AllianceBernstein to take advantage of the opportunities the market is providing," says Chris Winans, a spokesman for Axa Financial, a subsidiary of Axa.

Kraus says that withdrawals should slow this year, "assuming our performance continues to be positive. What we are doing is executing. We are out there hitting singles." Regaining credibility with investors may take time. "Investors have long memories, and it takes a while to regain their favor," says Burton Greenwald, an independent mutual-fund consultant in Philadelphia. "There is no shortage of other choices in this business." *—Charles Stein*

***The bottom line*** *Poor performance by AllianceBernstein stock funds led investors to pull $126 billion from the company in 2009 and 2010.*

**3.0**

MILLION DOLLARS

**Estimated profit that David Sokol, who has resigned from Berkshire Hathaway, earned on his Lubrizol stock when Berkshire agreed to buy the company for $9 billion in March.**

DATA: BERKSHIRE HATHAWAY, BLOOMBERG

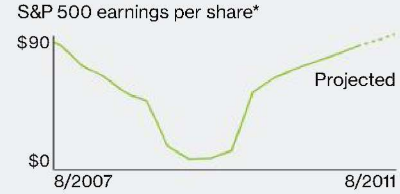
Investing

# Record Earnings Point To Stock Market Gains

▶ **Individuals who missed the rally are piling in, providing more fuel**

▶ **A New High on the Horizon**

S&P 500 earnings per share*




*INFLATION ADJUSTED, PAST 12 MONTHS
DATA: BLOOMBERG, ROBERT SHILLER

Record corporate profits and buying by individual investors may help extend a rally that has nearly doubled the Standard & Poor's 500-stock index since the market bottom in March 2009. Companies in the S&P 500 are expected to see their earnings for the preceding 12 months reach a record $91 a share by August, according to estimates compiled by S&P and Bloomberg.

If earnings reach that level, they would surpass the previous peak of $90 a share reached in 2007. The 50-month rebound in profits, following a 92 percent drop during the global financial crisis, would be faster than the 52 months it took to recover from the bursting of the dot-com bubble in



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2000, when earnings fell 55 percent. Profits didn't recoup their 67 percent tumble during the Great Depression until 19 years later.

While earnings growth will slow in the second half, stock purchases by investors who missed the rally will keep pushing prices up, according to the Leuthold Group in Minneapolis. "People are more comfortable with the recovery than at any time over the last couple of years," says Doug Ramsey, director of research at Leuthold, which recommended buying equities four days before the bull market started in March 2009. "That's typically when retail investors regain courage" and may spur an additional rise of as much as 25 percent in the S&P 500 during the next 18 months. Mutual funds that invest in U.S. equities attracted about $12 billion of inflows since December, compared with $134 billion of redemptions during the previous six quarters, according to Investment Company Institute data.

Analysts disagree about whether the market is overvalued. Yale University economist Robert J. Shiller says U.S. equities are "expensive." The S&P 500's cyclically adjusted price-earnings ratio, a valuation measure Shiller popularized that is calculated by dividing the index's price by the average inflation-adjusted earnings during the past 10 years, is about 44 percent higher than the average since 1900.

Profits are being inflated by government attempts to stimulate the economy, and earnings will eventually "mean revert," says Rob Arnott, founder of Research Affiliates, which oversees $75 billion in Newport Beach, Calif. "When markets are expensive, you're better off letting somebody else bear the risk to pick up that last nickel in front of the steamroller," he says.

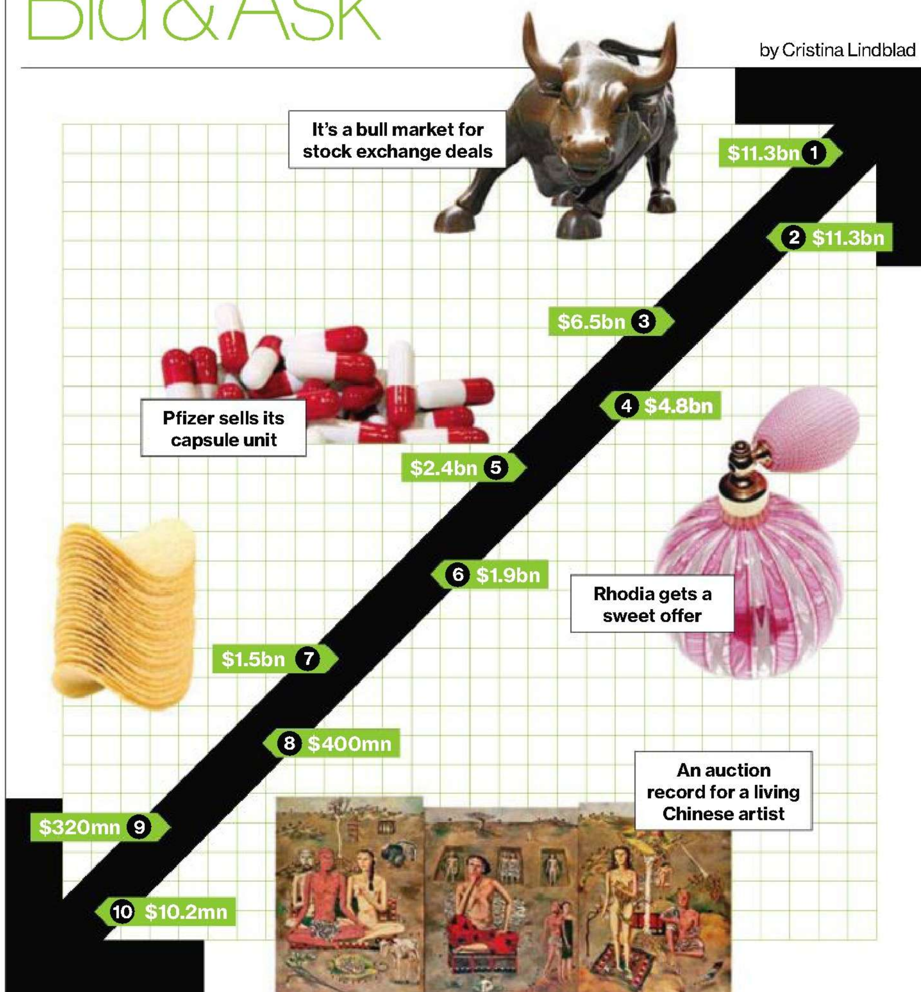
Linda Duessel, equity market strategist at Federated Investors, which oversees $358 billion, believes government stimulus has achieved its goal of creating a self-sustaining recovery that will endure even after stimulus ends. "We see accelerating growth around the globe," says Duessel, who turned bullish on U.S. stocks at the beginning of 2009. "This market looks cheap to us." B

*—Rita Nazareth and Michael Patterson*

***The bottom line*** *The market has doubled since March 2009. Record earnings of $91 a share and buying by individuals may keep the rally going.*

# Bid & Ask

by Cristina Lindblad




1 **Nasdaq OMX Group**, with IntercontinentalExchange, bid $11.3 billion for NYSE Euronext, topping an earlier offer from Deutsche Börse. The CEO of the all-electronic Nasdaq has pledged not to shut down the New York exchange's 108-year-old trading floor.

2 **Vivendi** is paying $11.3 billion for Vodafone Group's 44 percent stake in SFR to get full control of France's No. 2 mobile carrier.

3 **Texas Instruments** agreed to buy National Semiconductor for $6.5 billion, further cementing its leadership in the market for analog chips that go into everything from washing machines to military hardware.

4 **Solvay** offered $4.8 billion for Rhodia, a French specialty-chemical maker that supplies the cosmetics and auto-parts industries.

5 **Pfizer** sold Capsugel, which makes hard capsules for drugs, for $2.4 billion to a group of investors led by KKR.

6 **SRA International**, a provider of computer services to the U.S. government, agreed to be bought by Providence Equity Partners for $1. 9 billion.

7 **Diamond Foods** is paying $1.5 billion for Procter & Gamble's Pringles chip brand in a deal that will more than triple the size of its snack business.

8 **LivingSocial,** a smaller competitor of coupon site Groupon, raised $400 million from a group of investors including Amazon and T. Rowe Price. The transaction values the company at $3 billion.

9 Satellite TV provider **Dish Network** won an auction for the bankrupt movie-rental chain Blockbuster with a $320 million bid that beat offers from financier Carl Icahn and other investors.

10 A triptych painting by **Zhang Xiaogang** fetched $10.2 million, including fees, at a Sotheby's auction in Hong Kong, setting a new record for a work by a contemporary Chinese artist.

1: EIGHTFISH/GETTY IMAGES; 4: DIRK WESTPHAL/GETTY IMAGES; 5: MARK LENNIHAN/AP PHOTO; 7: DAVID J. GREEN-FOOD THEMES/ALAMY; 10: SOTHEBY'S/BLOOMBERG

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# Charlie Rose talks to Bob Diamond

## "I said, 'The time for remorse needs to be over.' ... It's time now to look at job growth"



MICHA THEINER/EYEVINE/REDUX

The CEO of Barclays talks about weaning economies from stimulus—and recalls the circumstances that drove Lehman into his arms

**You have said that the time for remorse is over.**
Aha, that's not what I said. I said, "The time for remorse needs to be over." And I think I was referring not, you know, to Barclays or to Bob Diamond, but really for the U.K., for the U.S., for government officials, for companies, for banks. It's time we focus on the things that are really, really important. We've been through a very difficult period. And every bank has made mistakes; every banker has made mistakes. But it's time now to look at job growth and economic growth. And I think it's time to balance regulatory reform ... with creating jobs and creating economic growth. And I think it's time to pass the mantle of growth to the banks and to the companies that can drive that growth.

**From governments to companies and banks?**
We've seen a lot of stimulus over the last couple years coming from governments. And using the U.K. as an example, the Prime Minister and the Chancellor of the Exchequer have been very clear that the issues around the deficit, around public spending, have to be addressed. So there is a comprehensive spending review. There's a reduction in public spending and the public sector. And that's necessary. And it's important. But that means that there won't be job creation or economic growth coming from the public sector. It's going to come from the private sector.

**When the crisis struck, you received two big loans—from Qatar and Abu Dhabi—and that enabled Barclays to avoid both bailout money and government capital restraints.**
That's right. We raised our equity privately. Barclays is one of the very, very few banks that never took any public money from any government anywhere in the world. We were profitable every single reporting period. We were able to acquire the Lehman Brothers U.S. business and Standard Life Bank in Scotland to add to our retail banking business in the U.K. And so we came out in a much stronger position than when we went in.

**About Lehman, tell me more about how it happened. You got a call from Bob Steel, Under Secretary at the Treasury Dept., now deputy mayor of New York?**
Yup, about a month after the Bear Stearns bankruptcy. He said this is unofficial and he's not proposing anything, but he wants me to think through two questions. Is there a price at which we'd been interested in Lehman? And, if so, what would we need from the Treasury?

**He was talking about you buying all of Lehman?**
At that time, certainly. I said to him: "That's a very good question. I'd like to take that away and give it some thought." In the back of my mind was just how suddenly the Bear Stearns deal had been put together. And I was curious about which other banks might have been called. Broadly, [Steel] was saying, "Be prepared." So I met with our executive team and we bandied it about. The strategic opportunity with the combination of Lehman and Barclays Capital was probably the best in the world. The Lehman businesses in equities and M&A were A-plus. It was a fantastic business.

**But their mortgage business was in trouble.**
To be fair to a lot of the people at Lehman, it was really the proprietary positions in commercial real estate that were the largest source of problems. There were some issues in subprime and mortgages but probably not any bigger than a lot of the other Wall Street firms.

**How much money would it have taken to buy Lehman prior to the bankruptcy?**
Our conclusion was, yes, this combination would be terrific. It would be transformational. There was a price that would work, but it would be very low.

**Suppose it had worked out. How would that have changed things? Because after Lehman, everything went to hell.**
If you look back at the time, two or three days before that Fannie Mae and Freddie Mac were nationalized. Within a day or two, we had a first run on a money market fund. On Monday, I think it was, Merrill was rescued by BofA. And within a week, the next Monday, both Morgan Stanley and Goldman Sachs were bank holding companies.

**But the psychological impact of Lehman ...**
Most people point to the Lehman bankruptcy as the trigger of the deepest, darkest fears that came. But would there have been another trigger had it not been that? It's really hard to say. B



*Watch Charlie Rose on Bloomberg TV weeknights at 8 p.m. and 10 p.m.*



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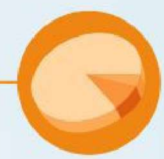
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# Bloomberg Government Insider

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Spring 2011 | bgov.com




# Cracking the Code

Complex and unfair, the U.S. tax system needs an overhaul. Here's how to get it done

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# Table of Contents

**Washington Briefing**
Why is it so hard to fix the broken U.S. tax code? B2

**Cover Story**
The corporate tax code treats similar companies very differently, as a comparison of Target and Amazon makes all too clear B4

**Taxation 101: Overseas Profits**
How countries tax earnings from abroad B8

**Tax Lab**
There is no shortage of ideas for simplifying the tax code. A sampling from the far-out to Old World tried-and-true: B10

**Fair Tax:** It sounds so simple—replace all levies with one sales tax. But what a headache

**Amnesty:** Letting tax scofflaws off the hook could fill federal coffers, but the states have seen mixed results

**VAT:** A sales tax on steroids, the value-added tax in Canada offers some lessons

**Flat Tax:** Slovakia's flat tax fired up foreign investment. Now the EU is pushing back

**Arbitrage:** Washington State has no income tax; Oregon, no sales tax. Their shortfalls? Huge

**Bright Ideas:** A CEO, a B-School dean, a labor leader, and a budget policy wonk on overhauling the tax code

**Playing the Tax Break Game**
The Senate Finance Committee helps its friends B18

**Point of View**
As Obama talks about overhauling the tax code, former New Jersey Senator Bill Bradley reflects on what it took to achieve reform in 1986 B20




# What Is BGOV?

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Washington Briefing

# Too Many Modest Proposals

Everyone says they want to overhaul the tax code. So why do lawmakers only tweak it?
**By David J. Lynch**

The U.S. corporate tax code is an opaque morass of special-interest giveaways. It distorts investment decisions, fuels CEOs' addiction to debt, and discourages corporations from settling in the U.S. Oh, and its 35 percent statutory rate is the highest in the world.

The need to lose this albatross is the rare area of agreement uniting President Barack Obama, his Republican adversaries, and Big Business. All say that lowering the corporate tax rate while closing industry-specific loopholes could give the U.S. economy a jolt of adrenaline and make life easier for corporate treasurers.

So why do tax experts doubt things will change any time soon? A quarter-century after the last overhaul of the tax code under President Ronald Reagan, would-be reformers confront interlocking political and financial dilemmas that will only become more vexing as the 2012 Presidential campaign approaches. "There's an illusion of consensus. Everybody's view of tax reform is different," says Martin A. Sullivan, a contributing editor at Tax Analysts, a nonprofit organization in Falls Church, Va. "I don't expect any real movement."

Few undertakings are more politically difficult than tax reform. Worse, economists say the lower-rates/broader-base concept now being floated by the Administration and lawmakers would likely have little immediate impact on the nation's principal economic headaches: the $1.6 trillion federal budget deficit and the 8.8 percent jobless rate.

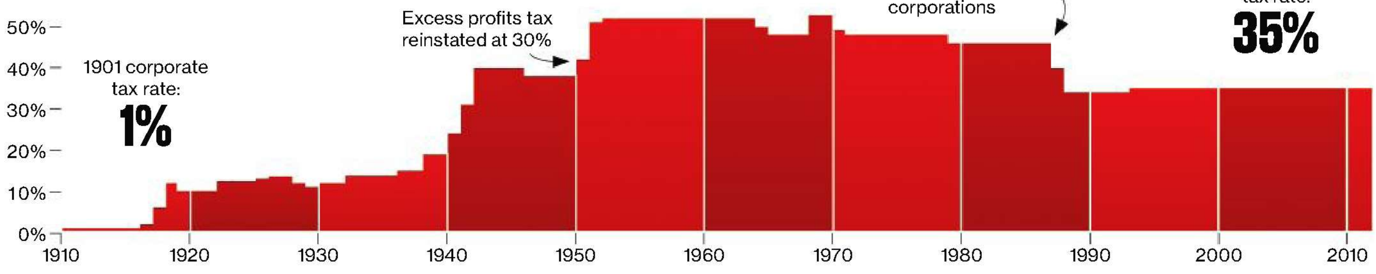
In December, the bipartisan panel appointed by Obama, the National Commission on Fiscal Responsibility and Reform, recommended using the proceeds from rewriting the tax code to pare the annual deficit by $80 billion in 2015 and $180 billion in 2020. Bowing to political reality, the Administration says it wants a revamp that would be "revenue neutral," meaning it wouldn't change the amount of cash coming into government coffers—or help close the deficit. Republicans have made no promises but reject any talk of increasing the government's tax take.

In any case, the immediate economic payoff from a new corporate tax code would be modest. "That's not where we should be looking in terms of employment effects," says Nariman Behravesh, chief economist for IHS Global Insight, who pegs the annual output gain from an overhaul at less than $100 billion. Mark Zandi, chief economist for Moody's Analytics, says a more competitive tax code would promote job growth over a decade or longer. "It takes time for the effects to be felt," he says.

For all its free-market brio, the U.S. has stayed on the sidelines of a global trend to cut corporate tax rates. From 2000 to 2010, the average statutory corporate rate among members of the Organization for Economic Co-operation and Development fell from 32.8 percent to 25.7 percent. Including subnational-level taxes, Japan's 39.5 percent rate is the world's highest. Prior to the earthquake, the Japanese government had announced plans to lop 4.5 percentage points off that rate in April, which would leave the U.S.'s 39.2 percent combined federal-and-state tax take as the globe's highest. Still, the U.S. now gets just 9 percent of federal tax receipts from companies, down from 32 percent in 1952.

Unlike most other industrialized nations, which tax corporations only on income earned in their native land, the U.S. taxes corporate income earned anywhere when it is repatriated. In a world of highly mobile capital, the American approach encourages companies to invest overseas and deters them from bringing home the profits from those operations. That explains why Corporate America is sitting on an estimated $1 trillion-plus in cash in offshore accounts. "The U.S. is an outlier on the corporate rate and the corporate tax system," says Alan J. Auerbach, a tax policy expert at the University of California, Berkeley.

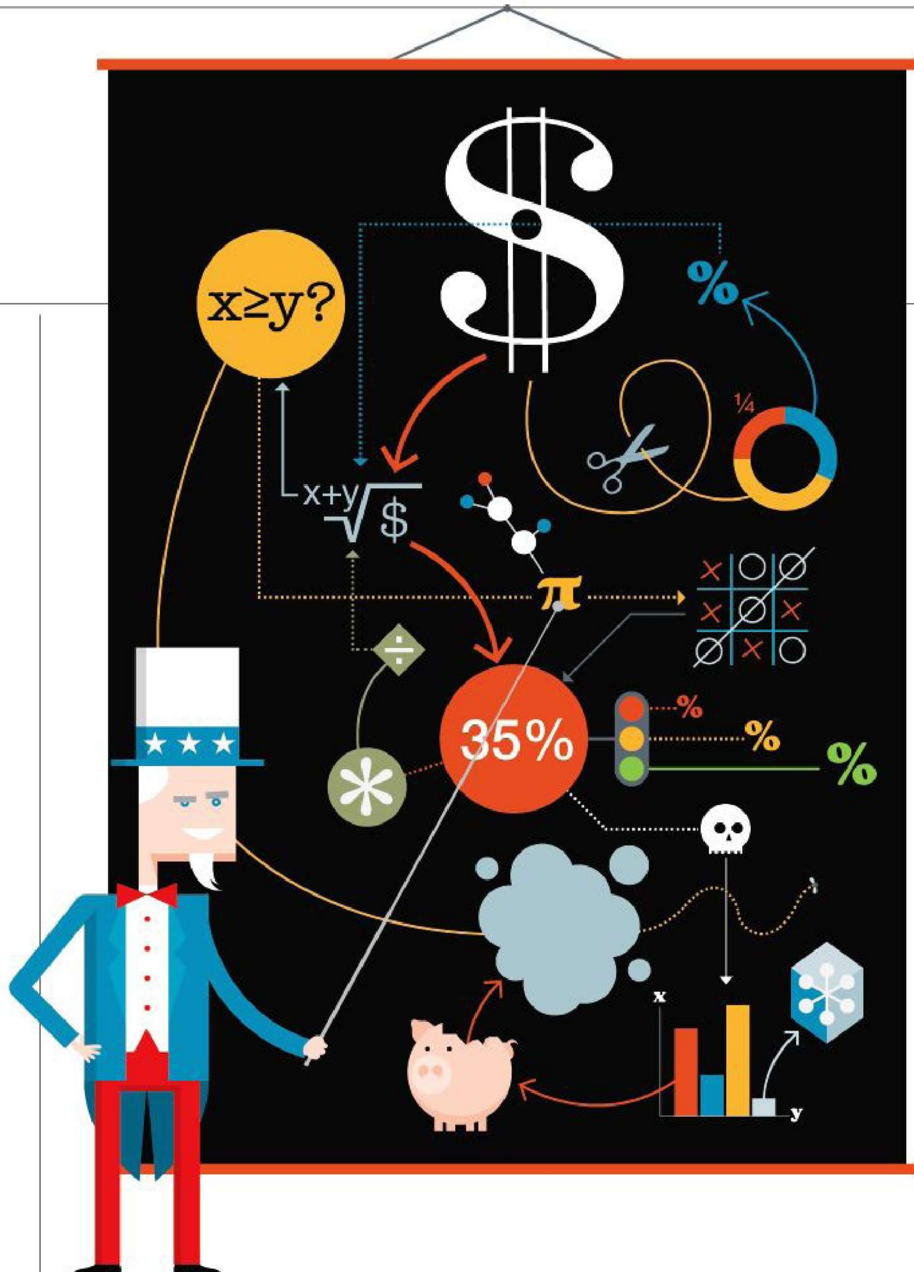
**A Century's View**
The evolution of the U.S. corporate tax rate




DATA: TAX POLICY CENTER



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"On the other hand, it's not that easy to see how to change the corporate tax in ways people like to see."

Lawmakers on both sides of Capitol Hill have begun hearings on potential reforms. Yet unlike in 1986, when Reagan threw his full weight behind a tax-code makeover, no champion has emerged to drive the process. In his January State of the Union address, Obama said of the corporate code: "It makes no sense and it has to change." But he has yet to offer a specific proposal.

Obama's fiscal commission recommended comprehensive change that would lower rates and eliminate "tax expenditures," the special deals–including some gift-wrapped for specific industries–that lower corporations' tax burdens. Such provisions cost the Treasury about $102 billion each year, according to the Tax Foundation, a nonpartisan group in D.C. A deduction for domestic production activities that especially benefits the oil, gas, and coal industries–just one of the myriad tax breaks–will lower corporate tax bills by more than $10 billion this year. Yet even if lawmakers could summon the political will to kill every one, the corporate rate would only drop to 28 percent in a revenue-neutral plan, according to Sullivan.

Business advocacy groups such as the Business Roundtable and U.S. Chamber of Commerce back a move to lower rates. CEOs such as Robert A. McDonald of Procter & Gamble complain that the current tax code puts the company at a disadvantage in global markets. "We pay about two percentage points higher corporate tax" than international competitors, McDonald told a House hearing in January. About 40 percent of P&G's total sales are in the U.S., yet the company makes 60 percent of its global tax payments to the Internal Revenue Service. In the quarter ended Dec. 31, P&G paid an effective tax rate of 17.9 percent.

Not all members of America Inc. are equally enthusiastic. One reason: The 35 percent rate only hits some industries. Computer and pharmaceutical companies, which can shift profitable operations to low-tax jurisdictions such as Ireland, pay much less. Over the past three years, General Electric, which has vast non-U.S. holdings, paid an effective tax rate of 3.6 percent, while retailer Wal-Mart Stores paid 33.6 percent.

Any move to lower rates by eliminating widely used deductions would arouse the ire of businesses that aren't structured as conventional corporations and pay taxes instead at individual rates. Partnerships and other businesses that file as S corporations–including hedge funds, law firms, and sole proprietorships–wouldn't benefit from a lower rate on corporate income, and they would lose valuable tax breaks for expenses such as interest payments and accelerated depreciation.

"With a revenue-neutral approach, you always have the problem that there are winners and losers," says Joel B. Slemrod, an economics professor at the University of Michigan's business school and a former senior tax economist on Reagan's Council of Economic Advisers. "And losers always shout louder than winners applaud." B

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Fairness Doctrine



# Wanted: A Tax Code for the Digital Age





## Amazon and Target are both in the retail business. You'd never know it from their tax bills

By Alison Fitzgerald and Catherine Dodge

Anyone who wants a Nintendo Wii console or the latest John Grisham novel can pick it up at the nearest Target store or log on to Amazon.com and have it delivered. The similarities between the two retailers aren't as apparent when it comes to taxes. Amazon's effective rate—the total it pays in federal, state, local, and international income taxes after deductions, along with its sales and property levies—has been more than 10 percentage points lower than Target's for the past four years. Target's effective tax rate in 2010 was 35.1 percent, compared with Amazon's 23.5 percent. Amazon in 2010 owed $352 million in income taxes worldwide on income of $1.5 billion, according to its SEC filings, while Target owed $1.58 billion on income of $4.5 billion. Amazon, the world's largest online retailer, has successfully resisted efforts from politicians to make it collect state and local taxes that brick-and-mortar rivals must charge. Tax laws "absolutely" put Target at a disadvantage, says Brian Sozzi, an analyst with Wall Street Strategies in New York. "It's one of the reasons why Amazon has been so successful."

These companies represent just one example of how the U.S. corporate tax code favors global companies over domestic ones, high-tech businesses over old-line manufacturers, and drugmakers over oil companies. The U.S. federal corporate tax rate of 35 percent is the highest in the developed world. Still, the Treasury Dept. says the federal government bleeds $1.2 trillion a decade as battalions of lobbyists, accountants, and lawyers create and promote more ways to avoid taxes.

This state of affairs has grown out of a political process where companies and their trade associations steer campaign money to lawmakers who write into laws special tax breaks for favored industries. "A tangle" is what George K. Yin, a former chief of staff for Congress's Joint Committee on Taxation and now a law professor at the University of Virginia, calls the tax code. "It is a very complicated society and economy that

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## Fairness Doctrine

we live in. You add to that the fact that we don't have all politicians with pure hearts and minds. And then you have all the different interest groups." Put it all together and what do you get? A 5,000-page document that in printed form weighs around nine pounds—as much as a large newborn baby.

The U.S. tax code was written at a time when American companies dominated the world economy and the Internet hadn't entered the imaginations of Defense Dept. scientists. The last major rewrite a quarter century ago didn't alter that basic structure, which taxes companies on worldwide income only when they bring home profits earned overseas. "We have lots and lots of tax preferences that reduce the effective rate," says Ed Kleinbard, a tax law professor at the University of Southern California and a former chief of staff of the Joint Committee on Taxation. Those preferences "distort decisions and are imperfectly distributed throughout the corporate sector."

The effect of the tax code on business behavior is clear when comparing Target and Amazon. Amazon, based in Seattle and founded in 1995, has made a series of moves to cut its tax bill since it became profitable in 2005. That year it established a European headquarters in Luxembourg, where the corporate income tax rate is 21 percent. The following year the company paid an effective tax rate of 49.6 percent as a result of selling assets to its Luxembourg subsidiary, according to its Securities and Exchange Commission filings. Since 2007, Amazon's effective tax rate has ranged from 27.9 percent to 21.9 percent. Executives at Amazon declined to be interviewed.

By moving intangible assets such as patents and intellectual property to low-tax countries, Amazon could then pay its subsidiaries in those countries for the use of the assets, cutting its income in high-tax jurisdictions. The practice, known as transfer pricing, is a common strategy global companies employ to reduce taxes. Those techniques "are not readily available to purely domestic firms," says Sullivan.

Amazon didn't disclose in its corporate filings exactly what assets it moved to other locations. However, the company holds 253 U.S. patents and 39 U.S. registered trademarks, according to the U.S. Patent and Trademark Office's online database. The patents include several for its Kindle electronic reader and for its recommendation system.

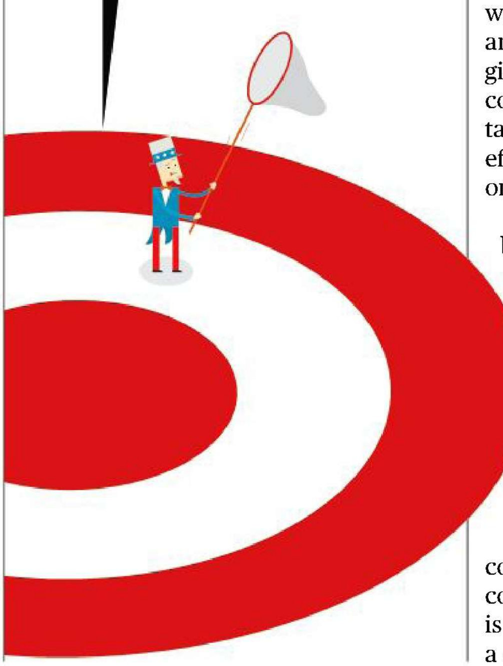
Amazon generates about 46 percent of its sales outside the U.S. Yet the tax benefit it derives from its foreign operations far exceeds the proportion of its international sales, says Robert Willens, a corporate tax specialist in New York. For the past three years, Amazon's tax rate on international income averaged 4.2 percent, according to its annual report.

Target, by contrast, makes all of its sales in the U.S. More than half its $44 billion in assets are land and buildings—hundreds of giant big-box stores that can't be transported to Luxembourg by signing a few documents. All of the company's trademarks, patents, and other intellectual property are owned by Target Brands, a subsidiary that is also based in the U.S., says spokeswoman Molly Koenst.

Target's tax disadvantage is compounded by the state and local sales taxes it is required to collect, which can add as much as 10 percent to the customer's final bill. Amazon, on the other hand, has fought for years to avoid having to do the same. It currently collects sales tax in only five states where it has a physical presence.

**35.1%**

**Target's effective tax rate in 2010**



The online retailer last month severed ties with all its affiliates in Illinois after legislators in Springfield approved a law requiring online companies that have affiliates in the state to collect state sales tax. A month earlier, Amazon said it would close an Irving (Tex.) distribution center after that state's comptroller sent the Web retailer a bill for $269 million in uncollected sales taxes.

Rachelle Bernstein, tax counsel to the National Retail Federation, a trade group representing brick-and-mortar retailers including Target, says retailers are burdened by the highest effective rates of any industry in the U.S. "Our members have for many years been supportive of tax reform that would lower the rate and broaden the base," she says.

More than half the companies in the Standard & Poor's 500-stock index had an effective tax rate of less than 30 percent. Carnival, the world's biggest cruise line company, which is incorporated in Panama, paid an effective tax rate of 1.4 percent, on average, from 2005 through 2010, according to Bloomberg calculations based on data from public filings. The rate for Agilent Technologies was 10.7 percent over the same period and 17.7 percent for pharmaceutical giant Pfizer. General Electric, the global conglomerate with a famously creative tax department, had a six-year average effective rate of 11 percent—in 2010 it was only 7.4 percent.

Oil giants ExxonMobil and Chevron, by contrast, have effective rates of more than 40 percent, in part because of the hefty fees they pay to countries where they lease oil rights. Other companies that don't fare so well are Goldman Sachs Group, with an effective rate of 32.7 percent from 2005 to 2010, and motorcycle maker Harley-Davidson, whose average rate was 36.2 percent.

The U.S. is among a handful of countries that tax profits earned in other countries, though only when the money is repatriated. This gives multinationals a decided advantage, says Chuck Marr,



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director of federal tax policy at the Center on Budget and Policy Priorities, a Washington research group. "Companies can operate in tax havens and leave money offshore, where a purely domestic firm would not have that."

Many U.S. multinationals would rather bring their cash home, where it can be reinvested into core operations. Ray Stata, chairman of Analog Devices, a Norwood (Mass.) electronics manufacturer, who also heads the Semiconductor Industry Assn., says the industry has "gobs of money" sitting overseas. He spent two days in March lobbying members of Congress to shift the U.S. to a territorial tax system, where only profits earned domestically are taxed (page B8).

Some multinational companies have banded together to press lawmakers for a temporary repatriation holiday to allow them to bring their profits home at a lower rate. A tax holiday would give global companies, including Amazon, another advantage over domestic counterparts such as Target. Some Republicans in Congress, led by House Majority Leader Eric Cantor (R-Va.), support the idea. The Administration says it will consider a tax holiday only if it's part of an overall corporate tax overhaul.

President Barack Obama in his fiscal 2012 budget proposal called for lowering the corporate tax rate while eliminating deductions and exemptions so the Treasury can collect the same amount of revenue. Cantor and House Ways and Means Committee Chairman Dave Camp (R-Mich.) have said they'd like to see the rate fall to 25 percent, yet they have not stressed the need to make up for lost revenue. "The high corporate tax rate is a big problem because the statutory rate, the 35 percent rate, is what motivates behavior," says Martin A. Sullivan, an economist at Tax Analysts in Falls Church, Va. "If I want to do some tax sheltering, if I want to do some borrowing, all of that is based off of the corporate rate."

Even with a high top rate, U.S. corporate tax revenue as a share of the economy has declined since the 1950s. It then made up 4.7 percent of gross domestic product, according to an analysis by the Center on Budget and Policy Priorities. From 2000 to 2009, corporate tax revenue averaged just 1.9 percent of GDP. Corporate taxes accounted for 11 percent of



**23.5%**

**Amazon's effective tax rate in 2010**

federal revenue in the last decade, down from 30 percent in the 1950s.

One reason is that many owners are able to organize their businesses as "small business corporations" and pay taxes under the individual income tax code. These so-called S corporations—and other entities including partnerships and limited-liability companies—are not subject to corporate taxes. Profits at S corporation are taxed once, at an individual rate, when the cash flows to the owners. The strategy helps avoid what economists say is the double taxation of traditionally structured corporations, or C corporations. These businesses pay taxes on their profits at the corporate rate and then the owners or shareholders pay tax again on those profits when they are distributed as dividends.

Obama's call to lower the 35 percent top tax rate won't benefit all businesses equally. Unlike multinationals and other C corporations, S corporations, which pay taxes at the individual rate, would be unaffected by the cut. They may even wind up paying more if, as Obama has suggested, the cost of the reduction is offset by eliminating deductions for expenses, such as interest costs, available to all businesses, including S corporations.

Economists and Administration officials say the tax laws encourage companies to make decisions based on reducing their tax burden rather than on what's best for their business. Obama, in his Jan. 25 State of the Union address, said he wants "the market to decide which businesses grow, not the community of tax lobbyists and tax planners."

The bipartisan panel appointed by Obama to come up with a plan to reduce the federal deficit and debt—the National Commission on Fiscal Responsibility and Reform—has proposed dropping the corporate rate to 28 percent. Each percentage-point reduction in the 35 percent corporate rate, however, could cost $8 billion or more a year in forgone revenue to the Treasury, according to the Joint Committee on Taxation. On that basis, the panel recommended eliminating almost all business tax breaks to ensure the lower rate doesn't increase the deficit.

To say that would be difficult is a colossal understatement. Many companies are deeply attached to their special tax benefits. Analog Devices' Stata says cutting the rate shouldn't depend on raising the same amount of money by eliminating deductions. "The scary part of this is the revenue-neutral part," he says. "We're trying to figure out how not to end up worse off."

Senator Ron Wyden (D-Ore.), a member of the tax-writing Finance Committee, last year introduced legislation to lower the top corporate tax rate to 24 percent in exchange for eliminating special preferences—especially those that encourage businesses to go offshore. He says he's "upbeat" about prospects for a tax-code overhaul, in large part because it can create jobs. "If you look at the two years after the last major tax reform bill in 1986, our country created 6.3 million nonfarm jobs," he says.

Wyden says he's working to build support among Democrats and Republicans "so that when all the interest groups mobilize and say, 'You take away my tax break and Western civilization is going to end,' you've got a bipartisan coalition with strength to hang in there and beat them."

After all, unlike the health-care overhaul Congress passed last year, it's not as if the U.S. hasn't done this before. Says Wyden: "No senator is going to face a town hall meeting where people say, 'Keep your cotton-picking hands off the tax code I love.'" B —*With Rich Miller and Richard Rubin*



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## By the Numbers

# Taxes 101: A Comparative Perspective

When U.S. corporations earn profits from their overseas subsidiaries, they can either bring the income back home or keep it invested overseas. Most developed countries use one of two systems to tax such profits: worldwide or territorial. Here are the basics of each and examples of countries that use them

*By Matt Caminiti and Paul Hughes*

### Worldwide System

Countries: U.S., Mexico, South Korea

#### How it works

- Under the U.S. variant of the system, all profits are taxed at the home country's rate, regardless of where they are earned.
- A company can claim a foreign tax credit for taxes paid to other governments.
- Corporations may defer home country tax on active foreign earned income until that income is repatriated.
- Passive income, or profits earned from so-called intangible sources such as interest, is taxed in the U.S. as it is earned, regardless of whether it is repatriated.

#### Pros

Companies face the same tax rate on domestic and international income.

#### Cons

- Deferral provides an incentive for companies to reinvest their profits overseas to avoid the higher U.S. tax rate.
- U.S. companies pay higher taxes than their foreign rivals when they compete abroad.

### Territorial System

Countries: Germany, U.K., Japan

#### How it works

- A company is allowed an exemption for income repatriated from foreign subsidiaries. The exemption essentially allows overseas profits to be untaxed and immediately brought home.
- Some countries, such as Japan and Germany, exempt only 95 percent of repatriated profits.

#### Pros

- Eliminating tax on repatriated income encourages companies to bring profits back home. This may spur investment and create jobs.
- Governments do not have to track how much tax was paid to other countries, since there is no need for a foreign tax credit.

#### Cons

- Exempting repatriated profits from tax may lower government revenues, as companies have an incentive to shift operations and income to countries with low tax rates.
- Countries must determine how to allow companies to deduct business expenses–either against domestic income, overseas income, or both.



### Where Cash Takes a Holiday

Congress in 2004 passed a law that allowed most profits repatriated to the U.S. to be taxed at 5.25 percent instead of 35 percent for a temporary tax holiday. Companies have used accounting techniques to shift their offshore profits to countries with low corporate tax rates–or none at all. Here are some of their favorite locales:

#### Bermuda

**2006 GDP** (2006 U.S. dollars) | **Untaxed profits** (2006 IRS data)



$5.4 billion | $51.1 billion

Bermuda's zero percent tax rate encourages U.S. businesses to set up holding companies in the country.



#### Netherlands

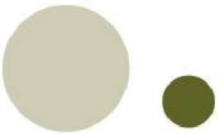


$677.7 billion | $42.0 billion



A "Dutch sandwich" transaction allows companies to route business transactions through subsidiaries and holding companies in Ireland, Bermuda, and the Netherlands to avoid income tax.

#### Ireland



$221.7 billion | $37.6 billion



Using a "double-Irish" transaction, a U.S. company can route its intellectual property sales through an operation in Ireland and another in a tax haven. That allows firms to circumvent any tax on the intellectual property.

#### Cayman Islands



$2.3 billion (2003 DATA) | $28.1 billion



Ugland House in the Cayman Islands is the registered address for 18,957 companies. The Caymans' zero percent tax rate encourages U.S. businesses to establish holding companies there.

SOURCES: WORLD BANK; FEDERAL RESERVE; IRS; U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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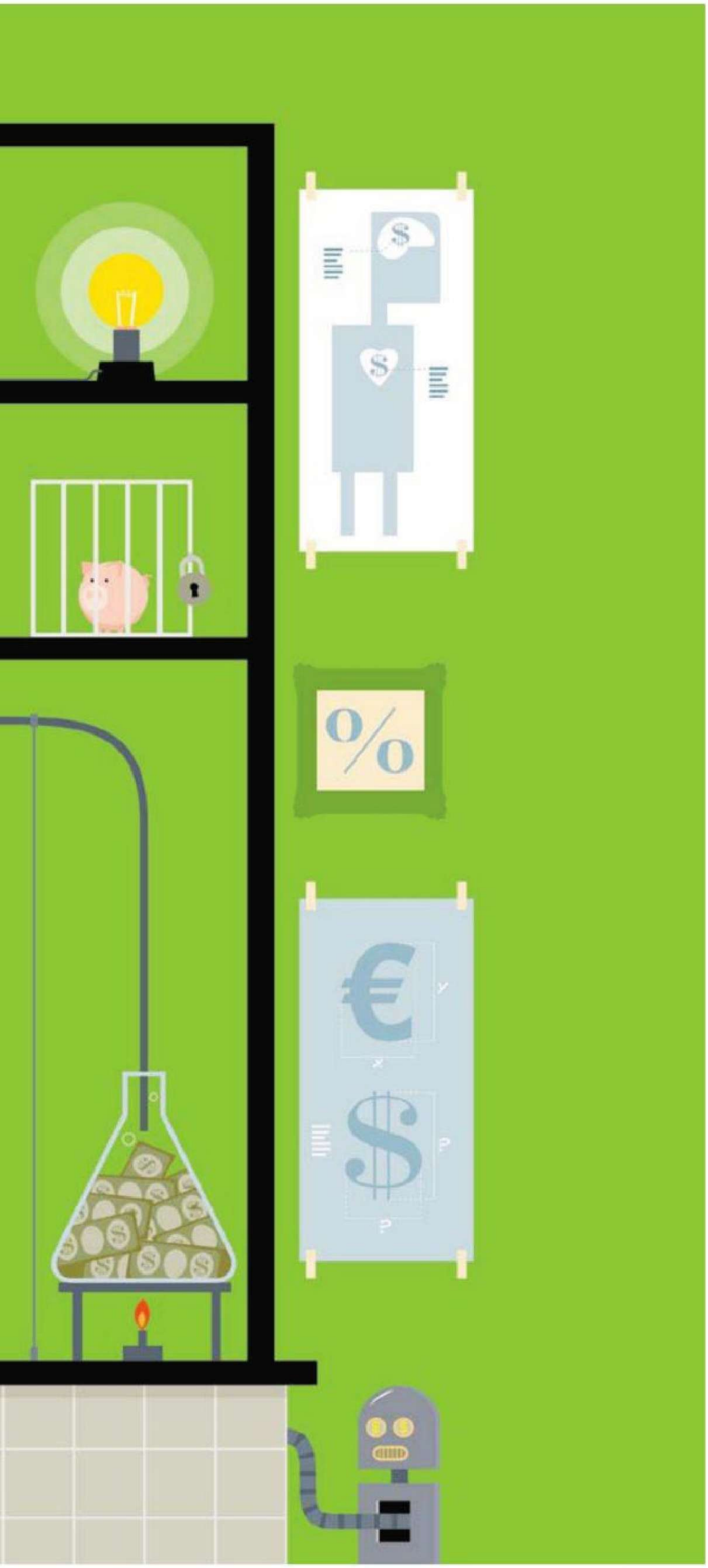
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# Field Notes






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# Tax Lab

There are a lot of ideas on how to "fix" taxes, though many conflict with each other and most fail. From around the world, here are some current prescriptions.

## 1

### Fair Tax
### A Simple Idea Full of Complications

It's a great idea—on paper: Scrap the individual income tax, the estate tax, the payroll tax, and the corporate income tax, and replace them all with a single, 23 percent national sales tax. This would boost the economy by eliminating red tape and removing loopholes that clutter the tax code. At least, that's the case made by proponents of the so-called FairTax, a group that includes about one-fourth of House Republicans.

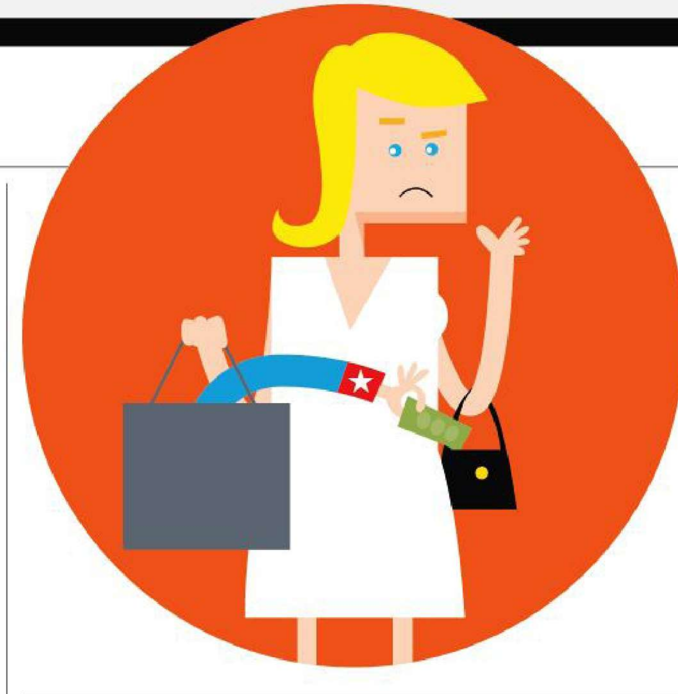
A legislative proposal to eliminate most existing tax law and put the FairTax in its place was introduced in the House in 1999 but never moved out of committee. Now supporters, energized by Republican gains in the midterm elections, are taking another stab at making it law. "The FairTax makes it so no individual ever has to deal with the tax man again," says Representative Rob Woodall, a freshman Georgia Republican who is the lead House sponsor of a 2011 bill.

Boosters say the FairTax is elegant in



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# Field Notes



its simplicity. Yet part of the reason the idea hasn't caught on beyond a core group of conservative advocates is that it's more complex than it seems. It isn't the same as a flat tax, which is based on income. It also isn't akin to the value-added taxes used around the industrialized world, which are collected at the producer and wholesale levels, as well as at the point-of-sale. The FairTax is like the sales taxes that many U.S. states charge, though critics contend that the way it is calulated makes it actually a 30 percent levy, not 23 percent (see graphic).

The 23 percent rate is set at a level designed to raise the same amount of revenue as the taxes it would replace. Yet it assumes full compliance. If experience is any guide, that's too optimistic: The current tax code, even with safeguards such as W-2 forms and automatic withholding by employers, leaks roughly $300 billion a year due to avoidance and evasion.

To generate sufficient revenue, the FairTax would have to be applied to goods and services that Americans are not accustomed to paying taxes on, such as rent, new-home sales, legal fees, and health care. If a political decision were made to exempt some categories, those that remain would require a higher rate. "The notion that we'd be able to get a clean tax that taxed everything at the same rate seems fanciful," says William G. Gale, a senior fellow at the Brookings Institution in Washington. "No country in the history of the world has done that."

The higher the tax rate, the greater the incentives for consumers and retailers not to report cash transactions. That would mean the economic jolt that FairTax supporters envision wouldn't materialize, Gale says. "We stall on the question of: Is it enforceable?" he says. "I just don't think it passes the laugh test at that level."

The FairTax would weigh heavier on lower-income households, because they spend a larger proportion of what they earn. That's why Woodall's proposal calls for a "prebate," a monthly advance rebate that covers the cost of the tax up to the federal poverty level. Compared with the current system, the FairTax would be a boon to the highest earners, who spend a relatively low share of their income each year and would no longer have to pay taxes on capital gains. FactCheck.org, a nonpartisan group at the University of Pennsylvania, estimated in 2007 that the proposal would translate into a tax increase for people making between $15,000 and $200,000, compared with the current system.

Woodall has heard all these complaints before, yet he thinks the FairTax is an idea whose time has come. To fulfill his dream, he sees an opportunity to harness the energy of his fellow freshmen legislators, who aren't yet attached to particular tax breaks that would disappear if the plan were enacted. "Call me a freshman optimist," he says, "but I see those opportunities for people to say: 'You know what, there are some big ideas out there, and let's team up to make them happen.'"

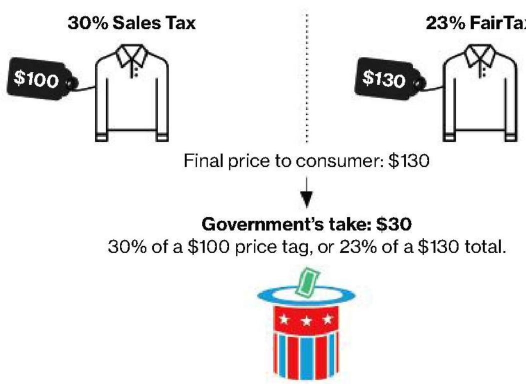
Representative Patrick J. Tiberi, an Ohio Republican who chairs a crucial tax-writing subcommittee, believes the FairTax is not politically viable. Yet the U.S. tax code, he says, is too broken to delay repair. "We would be not very smart if we wait until the perfect time," says Tiberi. "We have to do something today to make our tax code fairer, simpler, and pro-growth."

—*Richard Rubin*

***The bottom line:*** *A proposal to replace all levies with a 23 percent sales tax is unlikely to advance in Congress.*

**Crunching the Numbers**

The 23 percent FairTax yields the same revenue to the government as a 30 percent sales tax. Consider the following example.






## My Bright Idea

## Daniel DiMicco, CEO, Nucor

One proposal currently making the rounds is to allow American multinationals to repatriate offshore earnings—estimated at over $1 trillion—back to the U.S. virtually tax-free. Critics are worried the proposal won't result in economic stimulus. But we could guarantee a positive economic benefit if that money coming back went into infrastructure bonds. Updating our crumbling infrastructure would create jobs and keep us economically competitive. Each $1 billion spent on infrastructure creates 35,000 jobs. Companies would be able to draw that money back over time, once the economy has recovered and the government has recouped the cash in tax revenue.

JEFFREY CAMARATI/BLOOMBERG; OPPOSITE PAGE: JONATHAN FICKIES/BLOOMBERG



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# 2

## Tax Amnesty The Dangers Of Defanging The IRS

Seeking revenue to help fill a gaping budget hole, officials in New Jersey two years ago made an offer to tax cheats: Those who owed could come clean and pay up, with no penalties and no questions asked.

The state's tax authorities initially estimated the effort would bring in about $200 million. The final take was beyond their wildest expectations. Tax delinquents came forward with about $700 million.

Now, with a gap of about $345 billion a year between what U.S. taxpayers pony up and what they owe in federal taxes, some analysts say it may be time for the Internal Revenue Service to try a similar tactic. "All of a sudden these people can come out of the darkness, and the government collects a lot of money," says economist Arthur B. Laffer, former adviser to President Ronald Reagan and author of a 2010 book that calls for a federal tax amnesty.

Since the 1980s, 45 states and two cities have enacted amnesties, according to the Federation of Tax Administrators. At the federal level, lawmakers considered the idea in the 1980s and 1990s, though no broad initiative was ever enacted. Limited federal programs have allowed taxpayers to avoid criminal penalties for reporting cash stashed in offshore accounts.

Proponents say a federal tax amnesty would encourage payments from people who haven't come forward because they are afraid of the civil and criminal penalties they might incur. Critics, meanwhile, say it would do more harm than good because taxpayers will lose their fear of the IRS and stop paying taxes, expecting that they could make good the next time the U.S. government offers a reprieve. "It actually reduces compliance with the rules," says Martin Sullivan, an economist at Tax Analysts, a nonprofit publisher of tax information based in Falls Church, Va. "In the long run, it's a revenue loser."

Indeed, the last time congressional tax experts grappled with the issue in the 1990s, they estimated that waiving tax penalties would cost the U.S. $8 billion over 10 years. A 2010 New York tax amnesty netted just $45 million, while state officials had hoped to collect at least $250 million. Critics said the program was not well publicized.

In a way, the debate over tax amnesty comes down to differing views of human psychology. Laffer thinks a federal tax amnesty could bring in a one-time windfall of $600 billion to $800 billion. And far from reducing compliance, he thinks it would increase the likelihood that former tax scofflaws would continue to pay their taxes. "Once these guys are above the ground, they'll never cheat again," he says. Consequently, Laffer estimates federal revenue would increase by about $60 billion a year in the wake of an amnesty.

Yet even advocates of amnesties say they should be carried out carefully: Delinquent taxpayers must be convinced they are getting a one-time opportunity. Tougher penalties must follow the reprieve, to encourage people to come forward. Former IRS Commissioner Fred Goldberg, who also served as President George H.W. Bush's top tax policy official in 1992, says he dislikes the term amnesty. Instead of enacting a short-term program, he says, the IRS should take broader steps to make it easier for people to voluntarily pay delinquent taxes. "If you make a true voluntary disclosure, you should never be subject to criminal prosecution," says Goldberg.

Even that is a matter of debate. Sullivan thinks IRS penalties are a powerful deterrent. "As much as we all hate the IRS, there is something we should really cherish about it, which is that when people fear the IRS, they comply with the law," he says. —*Clea Benson*

***The bottom line*** *A national tax amnesty might raise badly needed revenue. Yet programs at the state level have had uneven results.*



### My Bright Idea
### Glenn Hubbard, Dean of Columbia Business School

Replace our current tax system with a broad-based, proportional consumption tax, with an exemption and refundable credit for low-income households. During a transition: Reduce current tax expenditures on health care and housing and use revenue from a consumption tax to decrease the current income and payroll taxes. A caution: The fate of the Tax Reform Act of 1986 teaches us that "broaden the base, lower the rates" within the income tax isn't sufficient, as keeping complexity and distortions at bay has proven difficult.



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# 3

## Value-Added Tax
## The Levy Canadians Love to Hate

Canada has it. Every other major industrialized economy has also adopted it. When it comes to the value-added tax, the U.S. is the only outlier.

Proponents of the VAT say the system is superior to the sort of retail sales taxes currently imposed by many U.S. states. It's simpler to enforce and discourages evasion. More importantly, it provides a broad enough tax base to enable governments to lower income taxes and maintain current spending.

The VAT is applied at every level of production on most goods and services. Businesses collect the tax on what they sell, and they receive credits for taxes paid along the supply chain. So in effect companies pay a levy only on the value they add in production.

For U.S. policy makers pondering the VAT, the Canadian experience offers both positive and negative lessons.

The levy, which in Canada goes by the name of GST (for goods and services tax), was introduced at the federal level two decades ago. The move has allowed Canada to cut its corporate tax rate by about 20 percentage points since the mid-1980s, to about 30 percent, according to the Organization for Economic Co-operation and Development. That puts the Canadian corporate tax rate below the 35 percent rate imposed by the U.S.

What distinguishes Canada's VAT from those of other countries is its transparency. European governments embed it in the final price of goods and services. In Canada, it's applied at the cash register, for every consumer to see. Consumers are reminded of it "every day, multiple times," says Michael Smart, an economics professor at the University of Toronto. "It's a tax that Canadians love to hate above all."

Voters have exacted their vengeance at the polls. The Progressive Conservatives, the forerunner of today's ruling Conservatives, were almost wiped out in the 1993 federal elections after introducing the GST. The party returned to power in 2006 by pledging to lower the tax, which they did by 2 percentage points, from 7 percent to 5 percent.

The latest VAT casualty is former British Columbia Premier Gordon Campbell, who saw his approval rating plunge to as low as 9 percent last year after introducing a provincial VAT. Campbell resigned on Mar. 14, and voters in the province will hold a referendum later this year on whether to abandon the tax.

Nevertheless, the VAT's durability is testament to its effectiveness, according to its proponents. Since the GST was rolled out, most Canadian provinces have followed suit with their own VATs. Ontario, Canada's most populous province, adopted one last year. Today, 85 percent of Canadians pay both federal and provincial VATs. Says Smart: "The Canadian evidence is that it works."

If the U.S. were to consider adopting a VAT, lawmakers would need to assure voters of two things in order to overcome opposition: that the tax is revenue neutral, and that it won't hurt the poor. Len Farber, former director of tax policy at Canada's Finance Dept., recalls that the federal government mollified the public by cutting personal and corporate tax rates before introducing the GST. "It was hard enough to convince the population at the time that this was a revenue-neutral tax," Farber says. "If personal tax rates and corporate tax rates had not gone down, they never would have believed it."

In Canada, lower-income families receive quarterly refunds to help offset the tax, while basic grocery items such as milk and fruit are exempted altogether. "The real issue to overcome there, and that was our problem as well, is the distributive properties of it," says former Bank of Canada Governor David A. Dodge. "It's certainly not progressive." —*Theo Argitis*

***The bottom line*** *Canada has proven that a value-added tax works, and that the levy can be politically lethal.*



### My Bright Idea
## Richard Trumka, president, AFL-CIO

First, let the Bush-era tax cuts for the richest 2 percent expire. Collect a tiny 0.05 percent tax on a broad range of financial transactions. Ask millionaires to pay a surtax on income. Tax capital gains and dividends as ordinary income. And end tax incentives to export good jobs overseas. Sacrifice should start at the top, not with the bottom 90 percent, who have not benefited from the failed economic policies of the past 30 years. Using tax reform as an excuse to reduce rates for corporations and high earners—instead of reducing the deficit—is a sick joke.

ANDREW HARRER/BLOOMBERG



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# 4

## Flat Tax: Slovakia's Killer App

Nestled between Poland, Austria, Hungary, Ukraine, and the Czech Republic, Slovakia has become a top destination for companies looking to establish a foothold in Central Europe. Among its appeals are its free-market bent and educated workforce. Slovakia's chief selling point, though, is a 19 percent across-the-board tax rate.

Introduced in 2004, Slovakia's flat tax triggered a surge in foreign direct investment and paved the way for the country's adoption of the euro five years later. The regime is modeled on that pioneered in Eastern Europe by Estonia, which in 1994 began levying a single 26 percent tax on corporate and personal income; the rate is now 21 percent. Estonia has since lowered the rate to 21 percent. "I remember remarks about unfair tax competition," said Slovakia's Finance Minister Ivan Mikloš, who occupied the same post at the time, in an e-mail. "This criticism gave us free publicity and [put us] on the radar screens of investors."

A month after Slovakia introduced its own flat levy, South Korean carmaker **Kia Motors** announced it would build a new a €1.1 billion ($1.5 billion) plant. Auto-part suppliers such as Germany's **Continental** and **Visteon** of the U.S. soon followed. By 2007, the nation of 5.4 million people was logging annual growth of 10.5 percent, the fastest pace of any member of the European Union. "The rate itself was very important, since at that time it was the most beneficial among neighboring countries," says Dusan Dvorak, the spokesman for Kia's local unit. "The flat tax also increases the transparency of the business environment and simplifies planning."

A total of 11 countries across the region, including Russia, now have a flat tax. Slovakia is one of five that levies the same rate on corporate and personal income. The country also levies a value-added tax on goods and services. The value-added tax rate was set at 19 percent until 2009, when it was notched up to 20 percent to compensate for a slump in tax revenues from the auto industry.

**Eastern Bloc**
Several countries in Eastern and Central Europe have adopted a flat tax. Below are the rates that apply to corporations:




DATA: BLOOMBERG

Tired of seeing manufacturing jobs migrate east, Western Europe is pushing back. France and Germany, which tax corporate income at 34 percent and about 30 percent respectively, are behind a drive for a uniform system of corporate taxation throughout the EU. Eastern European nations that received bailouts have also come under pressure from the International Monetary Fund to make changes to their flat-tax regimes. Hungary, which this year began levying a 16 percent flat rate on personal income, recently scrapped plans to introduce a 10 percent flat rate for companies in 2013.

Slovakia has already made it clear that it intends to fight the EU tax harmonization plan. Speaking to reporters in Bratislava in February, Mikloš said, "We wouldn't mind if the corporate tax was harmonized in line with the Slovak model, but we're afraid it's not realistic to think we'll be able to reach a compromise that won't adversely affect our tax system." —*Radoslav Tomek*

***The bottom line*** *Slovakia's flat tax has ignited growth and investment. Others in the EU resent its advantage.*



My Bright Idea

## Robert Greenstein, executive director, Center on Budget and Policy Priorities

As Reagan economics adviser Martin Feldstein and former Obama budget director Peter Orszag suggest, let all of President Bush's tax cuts expire on time after 2012—not just for those at the top—to shrink projected deficits. Second, reform the tax code by lowering rates and broadening the base in ways that improve economic efficiency, increase progressivity, and raise revenue in the context of a broader deficit-reduction package—one with responsible savings in discretionary and mandatory programs, including reforms to slow the growth of costs throughout the U.S. health-care system.



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# 5



## Tax Arbitrage The Cost Of Beggar-Thy-Neighbor Policies

Soon after **Wells Fargo Securities** moved its Portland (Ore.) office to Vancouver, Wash., Marty Forsmann decided it was time to leave the city where she had spent most of her adult life and follow her employer just across the Columbia River.

Forsmann, a sales manager, traded in her Portland house for a two-bedroom condominium in Vancouver, ditching a state with one of the highest income tax rates in the country for one that has rejected the tax. "I got between a 9 and 10 percent increase in income because I no longer paid taxes," she says. Forsmann, 58, says the 2004 move has allowed her to sock more money into her 401(k) ahead of her June retirement.

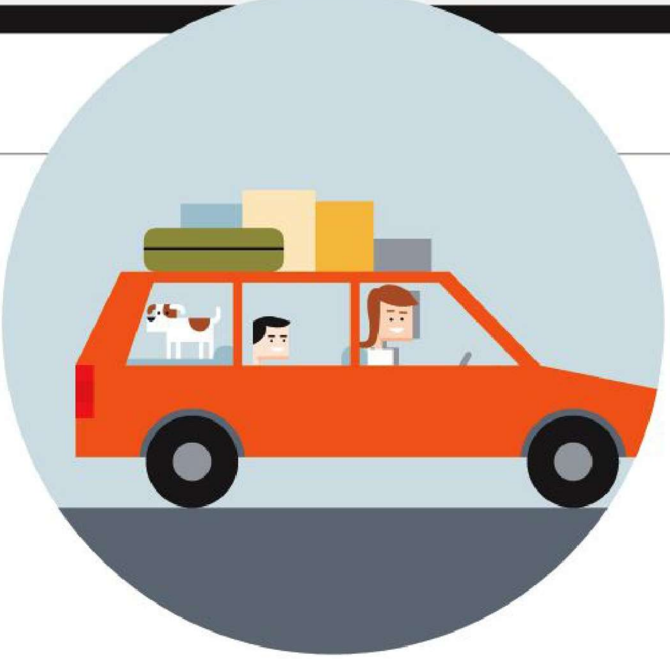
Washington, one of nine U.S. states that doesn't tax wages, imposes a 6.5 percent sales tax, along with local levies. Oregon, one of five states with no sales tax, has one of the highest income tax rates, especially for high earners: 10.8 percent for taxable income exceeding $125,000 a year and 11 percent for income greater than $250,000. "Oregon and Washington are mirror images of each other, but they are both unstable because they are missing a major component of what would be the best-case tax structure," says Remy Trupin, executive director of the Washington State Budget and Policy Center in Seattle.

The variation has made Vancouver a desirable place to live, allowing residents to work in Washington without paying taxes on their income while taking advantage of tax-free shopping along the northern Oregon border. "We call ourselves a tax haven in Vancouver," says David Knode, principal managing broker for **Coldwell Banker Seal**, a real estate firm there. "I see people primarily wanting to move over here because there's no income tax, property taxes are lower, and the housing prices are lower."

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The disparities come at a cost for both states. Washington is facing a $5.1 billion budget shortfall, and the state's localities lose an estimated $50 million in sales tax revenue annually to cross-border shopping, according to the Washington State Revenue Dept. Oregon, which is grappling with a $3.5 billion budget gap, lost more tax filers–7,652–to Washington than to any other state in 2008, according to the most recent data from the Oregon Revenue Dept.

The easiest way to stop the two states from bleeding each other would be for both to adopt the same–or at least a similar–tax structure. Yet multiple efforts to do just that have fallen flat.

In November, Washington voters rejected a proposal spearheaded by Bill Gates Sr., the father of **Microsoft**'s co-founder, to impose an income tax on those earning more than $200,000 a year. Critics said approving the tax for high earners would open the door to expanding it to other income brackets.

Meanwhile, Oregonians have rejected nine ballot measures proposing a sales tax. "Adding a sales tax in Oregon–they view that as a nonstarter as much as we do the income tax," says Bart Phillips, president of the Columbia River Economic Development Council in Vancouver. This is how it is in a democracy, says Douglas L. Lindholm, president of the Council On State Taxation, a trade association based in Washington, D.C., that represents more than 600 corporations engaged in interstate commerce. States are proud to be "laboratories," he says, "and tax policy is certainly a part of that." —*Alison Vekshin*

***The bottom line*** *Shortfalls in Oregon and Washington are aggravated by differences in their tax structures.*

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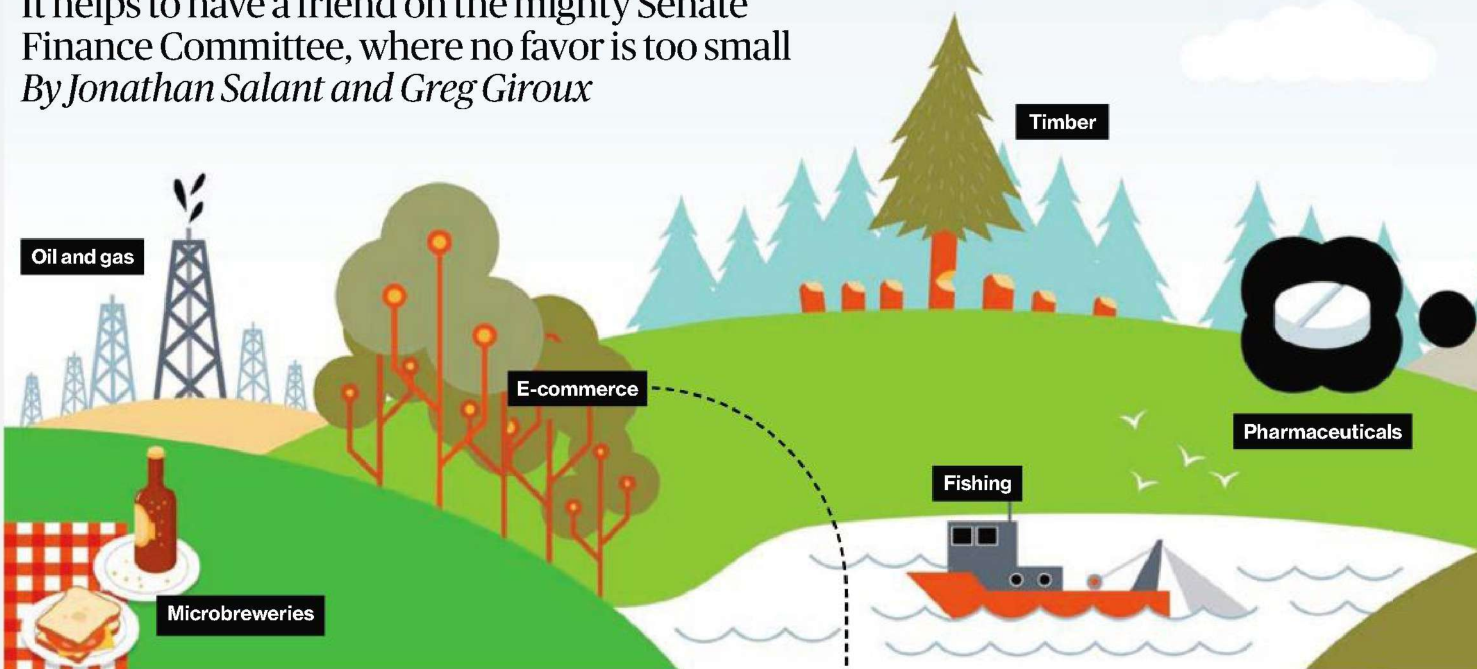
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**The Politics of Tax Reform**

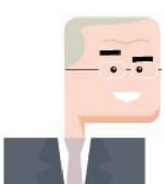
# Playing the Tax Break Game

## It helps to have a friend on the mighty Senate Finance Committee, where no favor is too small

*By Jonathan Salant and Greg Giroux*




← **Democrats**



### Robert Menendez

New Jersey

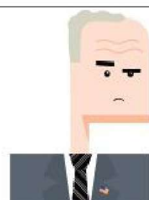
Championed a temporary tax credit to allow small companies to offset a portion of investments in therapies to prevent and treat acute and chronic diseases. The pharmaceutical industry contributed $434,043 to his campaign and leadership PAC for the 2010 elections. Several drugmakers, including Merck and Johnson & Johnson, are based in New Jersey.



### Debbie Stabenow

Michigan

Sponsored a bill to give consumers a tax rebate of up to $7,500 toward the purchase of hybrid gas-electric cars or trucks. The Chevy Volt plug-in model, made by Detroit-based General Motors, hit showrooms in November. GM employees gave $84,635 to Stabenow between 1995 and 2010, more than workers from any other company.



### Charles E. Schumer

New York

Pushed to ensure that proposals to tax carried interest of private equity fund managers at ordinary income rates also extended to partnerships in real estate and in the oil and gas industry. Republicans said Schumer's move made the tax increase harder to pass. It died last session. Schumer has received $8.8 million from the securities and investment industry since 1989.



### Ron Wyden

Oregon

Supports preserving the Internet tax moratorium, which blocks most states from imposing taxes on Web access fees. The Portland (Ore.) area is home to a cluster of technology operations—including a major Intel plant—known as Silicon Forest. The tech industry has given $416,423 to Wyden's campaigns since 1989, one of his largest sources of campaign cash.



### John F. Kerry

Massachusetts

Co-authored a bill with Republican Mike Crapo (opposite page) to reduce excise taxes for small "craft" brewers. There are 38 small breweries in Massachusetts, including Samuel Adams, the country's largest microbrewery, and 12 breweries in Idaho, which ranks third in U.S. production of hops, a primary ingredient in beer.



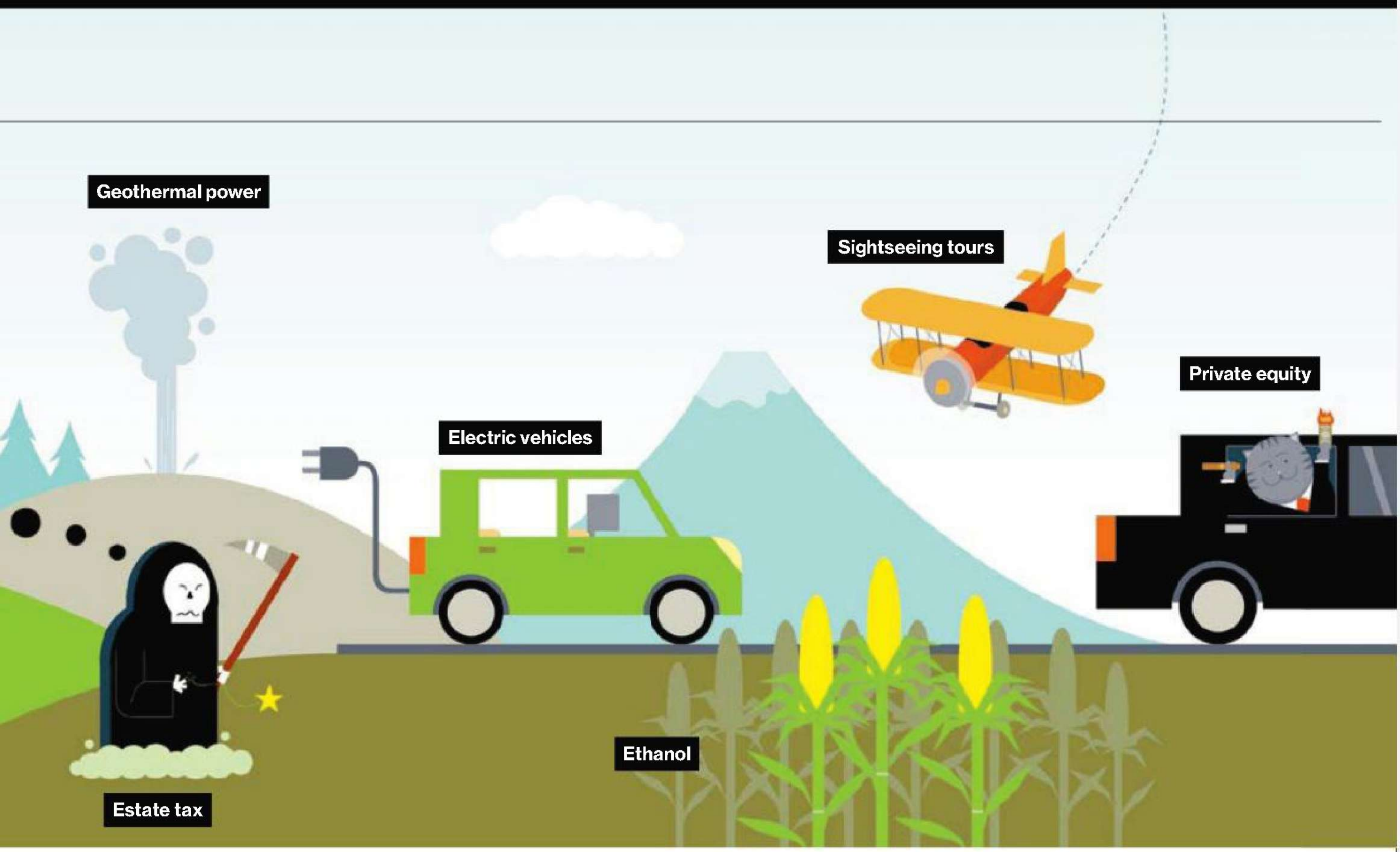
### Max Baucus

Montana, chairman

Obtained a provision in the farm bill for tax-exempt "forestry conservation bonds" to help purchase a 500-square-mile patchwork of land owned by Plum Creek Timber. Plum Creek, the biggest private landowner in Montana, spent $3.7 million on lobbying from 2006 to 2010, and its employees have contributed $19,100 to Baucus's campaigns.



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## Republicans →



### Charles Grassley

Iowa

Backs tax credits for U.S. producers of corn-based ethanol and tariffs on ethanol imports. Iowa's ethanol industry encompasses 40 plants producing more than 3.5 billion gallons of ethanol a year and using more than 1.1 billion bushels of corn, according to an industry trade group. Grassley received $290,250 from agriculture PACs for the 2010 election.



### Olympia J. Snowe

Maine

Pushed for tax provisions to help small businesses, including Maine fishermen. One allows companies to immediately write off up to $250,000 in new investment. She helped defeat a proposal in 2010 that would have raised taxes on professional-services businesses such as architecture firms.



### Jon Kyl

Arizona

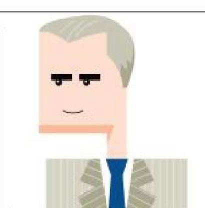
The No. 2 Senate Republican is a top proponent of cutting taxes on inherited wealth. He helped preserve a one-year repeal of the estate tax in 2010, then cut a deal with President Obama to set the estate tax rate at 35 percent for 2011 and 2012. Eliminating the estate tax was a priority of the Club for Growth, which has donated $155,753 to Kyl since 1989.



### Mike Crapo

Idaho

Wants to give the same tax breaks to geothermal power producers that are available for solar energy and fuel-cell technologies. There are 12 geothermal projects being developed in Idaho, which ranks third among 12 Western states in geothermal power potential, according to the Western Governors Assn.



### John Ensign

Nevada

Seeks to preserve favorable tax treatment in the Federal Aviation Administration reauthorization bill for small air-sightseeing tour companies in southern Nevada. Nevada officials attribute 427,000 jobs in the state and $2.4 billion in state and local tax revenue to the tourism industry.



### John Cornyn

Texas

Opposes the President's efforts to repeal oil- and gas-industry tax breaks. He criticized the Administration's temporary ban on deepwater oil drilling following the BP oil spill, saying it would "likely destroy tens of thousands of jobs." Oil and gas interests have given $1.7 million to Cornyn since 2001, more than any other industry.

NOTE: ALL DATA ON CAMPAIGN DONATIONS ARE FROM THE CENTER FOR RESPONSIVE POLITICS

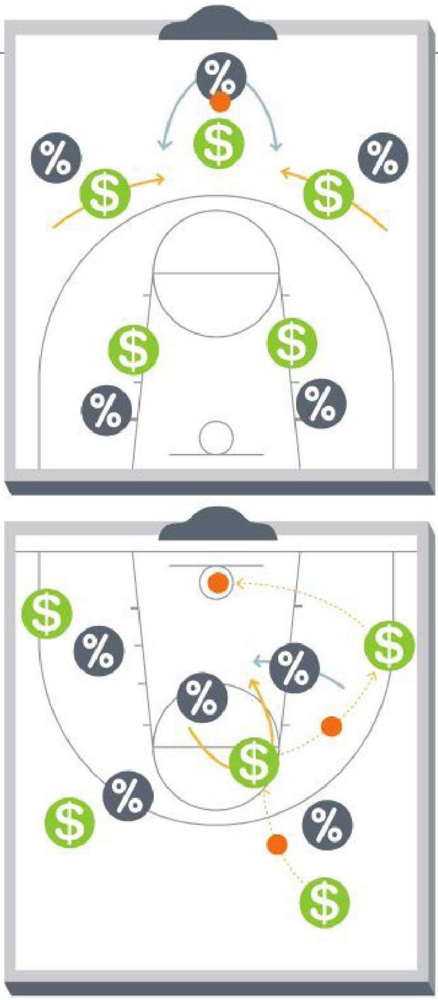
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## Point of View

# Tax Reform Is A Team Sport



The lesson from 1986 is that you need an all-star squad to win at this game, says former New Jersey Senator **Bill Bradley**



In 1986, Congress passed an income tax reform that reduced the top personal income tax rate from 50 percent to 28 percent and created a 15 percent rate for everyone else. It was paid for by closing billions in loopholes, those arcane provisions in the code that reduce taxes for their lucky beneficiaries but leave the rest of us paying more. The '86 reform was revenue neutral, neither raising overall taxes nor increasing the deficit. It was guided by three principles: equity–equal incomes should pay equal taxes; efficiency–the market is a better allocator of resources than members of Congress; and fairness–those Americans who have more should pay more.

In the beginning the pundits said tax reform had as much chance of passing as an elephant has of flying to the moon. The tax code was seen as a playground for Washington's special interests–an unfair burden the rest of America would just have to bear. Yet reform passed. Average taxpayers got to keep more of each additional dollar they earned, all corporations were treated more equally, and the wealthy ended up paying a higher percentage of total income tax revenue.

As President Obama talks of reforming the tax code again, the experience of 1986 taught me that there are six things necessary to achieve the goal, no matter how he chooses to define reform:

1. A President who is fully committed. Ronald Reagan, a Hollywood actor when marginal rates exceeded 90 percent, cared passionately about lowering them. Giving up loopholes to get lower rates was not a hard decision for him.

2. A Treasury Secretary who will get deeply involved and at crucial moments has enough command of the subject to negotiate a resolution. Jim Baker and his admirable assistant, Dick Darman, drove the process for President Reagan. At the end, Baker himself was negotiating specific detailed provisions.

3. A chairman of the House Ways and Means Committee who will use all available chits to bring recalcitrant congressional members to support the cause. The chairman must be self-interested in reform's success. For example, in 1986, Dan Rostenkowski embraced reform because it was big enough for his ambition. He had been lambasted for cutting special-interest deals to pass Reagan's 1981 tax cut. By 1986 he could cut loopholes and gain a good government imprimatur. "Rosty" also wanted to do reform because others said it could not be done. Success would mark him as the most effective chairman of the era.

4. A chairman of the Senate Finance Committee whose interests are also served by overseeing passage. Bob Packwood played that role in 1986. He was a late convert to the cause, but once there, he persuaded, cajoled, threatened, and outsmarted the opponents. In the process, Packwood found his liberal Republican legs and defended the bill in the best progressive tradition of Teddy Roosevelt. His achievement offered a contrast to the previous Democratic chairman, Russell Long, who had fought the very idea of tax reform for decades.

5. Followers who know the subject, enjoy dueling substantively with opponents, and pursue the goal single-mindedly. These members can create the energy for passage. In 1986, I played that role for Packwood and Rostenkowski. For four years I talked about practically nothing but tax reform.

6. Finally, a tireless staff, smart enough to master the arcane details of tax legislation and savvy enough to be able to advise their principals about how to deal with other lawmakers and the media. In 1986, Rostenkowski, Packwood, and Baker had such staff–and so did I.

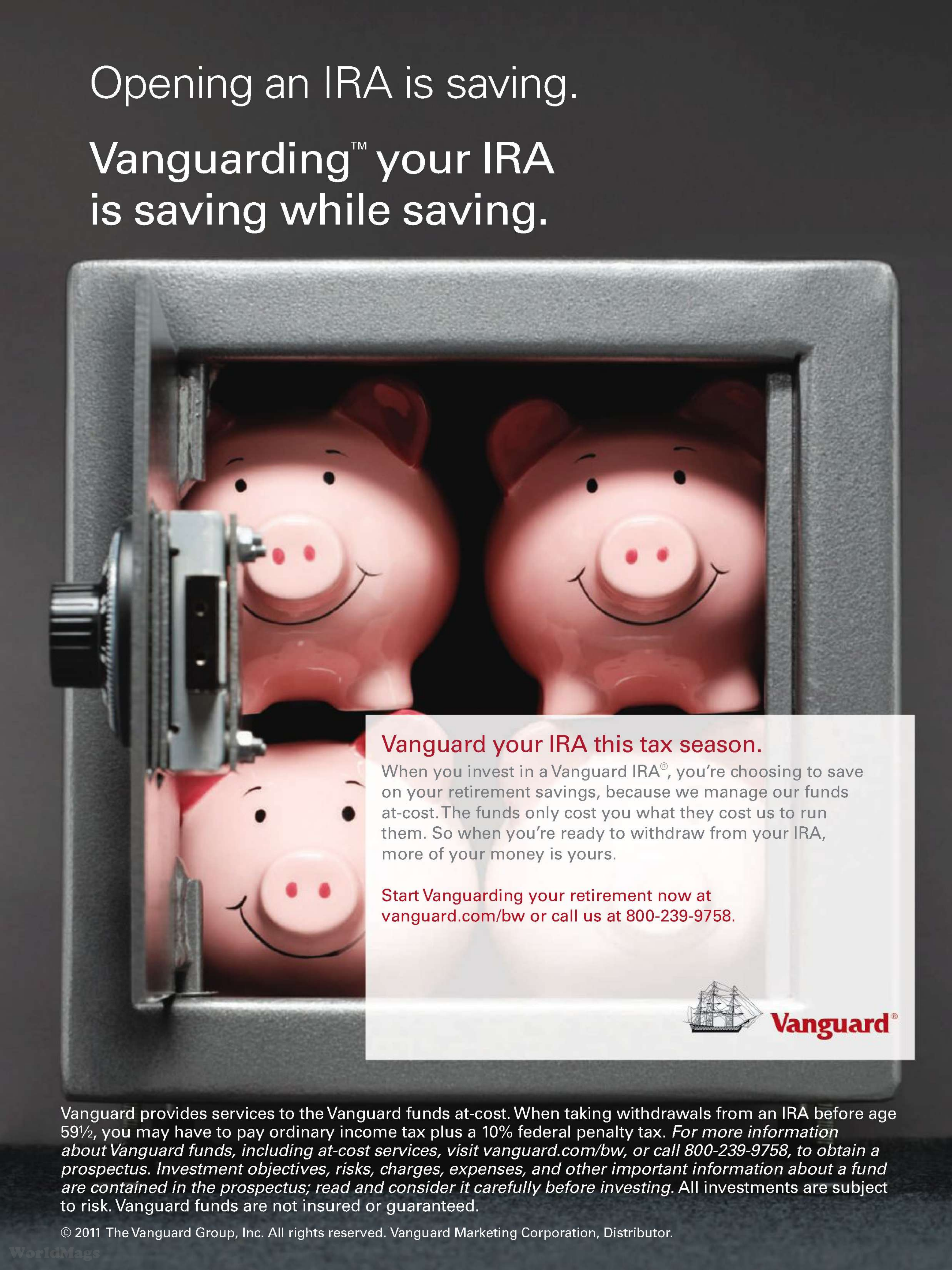
President Obama has a full plate, and the world's unpredictable economic events dominate Treasury Secretary Timothy Geithner's days. If the President does not have all six of these elements in place, he shouldn't waste his time. Yet if he does want to change the way Washington works–as he promised to do in 2008–there is no better place to start than with the shameful folly we call the 2011 income tax code. Ⓑ

**Bill Bradley, a former Democratic U.S. senator from New Jersey and onetime forward for the New York Knicks, is a managing partner of Allen & Co. in New York.**



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# THE MORE YOU MAKE, THE LESS YOU PAY

## The Billionaire's Guide to Paying No Taxes

By Jesse Drucker
Illustrations by Jennifer Daniel

For the well-off, this could be the best tax day since the early 1930s: Top tax rates on ordinary income, dividends, estates, and gifts will remain at or near historically low levels for at least the next two years. That's thanks in part to legislation passed in December 2010 by the 111th Congress and signed by President Barack Obama.

"This is clearly far and away the most generous tax situation that's existed," says Gregory D. Singer, a national managing director of the wealth management group at AllianceBernstein in New York. "It's a once-in-a-lifetime opportunity."

For the 400 U.S. taxpayers with the highest adjusted gross income, the effective federal income tax rate—what they actually pay—fell from almost 30 percent in 1995 to just under 17 percent in 2007, according to the IRS. And for the approximately 1.4 million people who make up the top 1 percent of taxpayers, the effective federal income tax rate dropped from 29 percent to 23 percent in 2008. It may seem too fantastic to be true, but the top 400 end up paying a lower rate than the next 1,399,600 or so.

That's not just good luck. It's often the result of hard work, as suggested by some of the strategies in the following pages. Much of the top 400's income is from dividends and capital gains, generated by everything from appreciated real estate—yes, there is some left—to stocks and the sale of family businesses. As Warren Buffett likes to point out, since most of



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his income is from dividends, his tax rate is less than that of the people who clean his office.

The true effective rate for multimillionaires is actually far lower than that indicated by official government statistics. That's because those figures fail to include the additional income that's generated by many sophisticated tax-avoidance strategies. Several of those techniques involve some variation of complicated borrowings that never get repaid, netting the beneficiaries hundreds of millions in tax-free cash. From 2003 to 2008, for example, Los Angeles Dodgers owner and real estate developer Frank H. McCourt Jr. paid no federal or state regular income taxes, as stated in court records dug up by the *Los Angeles Times*. Developers such as McCourt, according to a declaration in his divorce proceeding, "typically fund their lifestyle through lines of credit and loan proceeds secured by their assets while paying little or no personal income taxes." A spokesman for McCourt said he availed himself of a tax code provision at the time that permitted purchasers of sports franchises to defer income taxes.

For those who can afford a shrewd accountant or attorney, our era is rife with opportunity to avoid, or at least defer, tax bills, according to tax specialists and public records. It's limited only by the boundaries of taste, creativity, and the ability to understand some very complex shelters.

NOTE: CBO INCOME DEFINITION BROADER THAN THAT USED BY THE IRS DATA: CONGRESSIONAL BUDGET OFFICE, TAX POLICY CENTER

*“Strategies for raising cash tied to appreciated stock holdings yet deferring the accompanying tax are alive and well,” says tax adviser Robert Willens*

1

## The “No-Sale” Sale

**An executive has $200 million of company shares. He wants cash but doesn’t want to trigger $30 million or so in capital-gains taxes.**

1. The executive borrows about $200 million from an investment bank, with the shares as collateral. Now he has cash.
2. To freeze the value of the collateral shares, he buys and sells “puts” and “calls.” These are options granting him the right to buy and sell them later at a fixed price, insuring against a crash.
3. He eventually can return the cash, or he can keep it. If he keeps it, he has to hand over the shares. The tax bill comes years after the initial borrowing. His money has been working for him all the while.

### Executives Who Do It

Investor
**Philip Anschutz**

Entrepreneur
**Red McCombs**



### Seller Beware

The IRS challenged versions of these deals used by billionaire Philip Anschutz and Clear Channel Communications co-founder Red McCombs. A U.S. Tax Court judge last year ruled Anschutz owed $94 million in taxes on transactions entered into in 2000 and 2001. He is appealing the decision. McCombs settled his case last month. Despite the court cases, such strategies “are alive and well,” says Robert Willens, who runs an independent firm that advises investors on tax issues.





2

## The Skyscraper Shuffle

**Two people are 50-50 owners, through a partnership, of an office tower worth $100 million. One of the owners, let’s call him McDuck, wants to cash out, which would mean a $50 million gain and $7.5 million in capital-gains taxes.**

1. McDuck needs to turn his ownership of the property into a loan. So the partnership borrows $50 million and puts it into a new subsidiary partnership, which contributes the cash to yet another new partnership.
2. The newest partnership lends that $50 million to a finance company for three years in exchange for a three-year note. (The finance company takes the money and invests it or lends it out at a higher rate.)
3. The original partnership distributes its interest in the lower-tier subsidiary to McDuck. Now, McDuck owns a loan note worth $50 million instead of the property, effectively liquidating his 50 percent interest.
4. Three years later the note is repaid. McDuck now owns 100 percent of a partnership sitting on a $50 million pile of cash—the amount McDuck would have received from selling his stake in the real estate—without triggering any capital-gains tax.
5. While this cash remains in the partnership, it can be invested or borrowed against. When McDuck dies, it can be passed along to heirs and liquidated or sold tax-free. The deferred tax liability disappears upon McDuck’s death under a provision that eliminates such taxable gains for heirs.

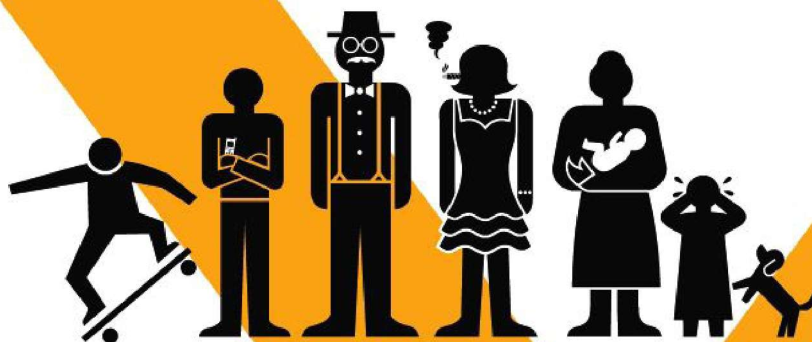
### Seller Beware

**Wealthy Boston real estate developer Arthur M. Winn used a version of this transaction. In 2008 a U.S. Tax Court judge ruled that one aspect of the deal was perfectly legal. Other aspects of the transaction are being settled with the government.**

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3

## The Estate Tax Eliminator

**A wealthy parent with millions invested in the stock market wants to leave future earnings to his kids and avoid the estate tax on those earnings.**

**1**
The parent sets up a Grantor Retained Annuity Trust, or GRAT, listing the kids as beneficiaries.

**2**
The parent contributes, say, $100 million to the GRAT. Under the terms of the GRAT, the amount contributed to the trust, plus interest, must be fully returned to the parent over a predetermined period.

**3**
Whatever return the money earns in excess of the interest rate—the IRS currently requires 3 percent—remains in the trust and gets passed on to the heirs free of estate and gift taxes forever.

**Executives Who Do It**






4

## The Trust Freeze

**A wealthy couple wants to leave a collection of income-producing assets, such as investment partnerships that own shares, valued at as much as $150 million, to their children. So they "freeze" the value of the estate at that moment, maybe 20 years before their death, pushing any future appreciation out of the estate and avoiding what could be a $50 million federal estate tax bill.**

**1**
The best approach is an "intentionally defective grantor trust." The couple makes a gift of $10 million—the maximum amount exempt from the gift tax for the next two years—to the trust, which lists the children as beneficiaries.

**2**
The trust uses that cash as a down payment to buy the partnership from the parents through a note issued to the parents, but the partnership contains a restriction on the trust's use of the assets, thus impairing the partnership's value by, say, 33 percent. That enables the trust to buy the $150 million partnership for just $100 million.

**3**
The income produced by the investment partnership helps pay off the note. The tax bill on that income is borne by the parents, essentially allowing gifts exempt from the gift tax.

**4**
When the note is paid off, the trust owns that $150 million worth of assets minus the $90 million note and interest—plus any appreciation in the meantime. The trust has swept up a $150 million income-producing concern without triggering the federal estate tax.

***Defective trusts are "a home run," says Gideon Rothschild, a partner at Moses & Singer***

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*"A company can't come to you and say we've got a couple of million for you at any time," without triggering a tax, says Robert Salwen, an executive compensation consultant, "but that's essentially what an option allows you to do."*



5

## The Option Option

**An executive is negotiating his employment contract for the coming five years. The company might offer millions in shares. But who wants to pay taxes on millions in shares?**

Better to take options. The executive owns the right to buy the shares at a time of his choosing; he's been compensated, but he hasn't paid any taxes. Gains from nonqualified stock options, the most common form, aren't taxed until the holder exercises them. That means the executive controls when and if the tax bill comes. It isn't just icing, either. Often, it's the cake. Lawrence J. Ellison, CEO of Oracle, earned $250,001 in salary in 2010 and was awarded $61,946,500 in options.

### Executives Who Do It

(CEOs or co-CEOs as of 2010): **FIRST ROW: Lawrence Ellison**, Oracle; **Philippe Dauman**, Viacom; **Michael White**, DirecTV; **Andrew Gould,** Schlumberger; **Dave Cote**, Honeywell; **David Pyott**, Allergan; **Marc Benioff**, Salesforce.com; **Sanjay Jha**, Motorola; **Richard Fairbank**, Capital One; **SECOND ROW: Howard Schultz**, Starbucks; **Jay Johnson**, General Dynamics; **Larry Nichols**, Devon Energy; **Muhtar Kent**, Coca-Cola; **Paul Jacobs**, Qualcomm; **James Rohr**, PNC Financial; **Louis Chênevert**, United Technologies; **Fred Smith**, FedEx; **Bob Kelly**, Bank of New York Mellon; **THIRD ROW: William Weldon**, Johnson & Johnson; **Clarence Cazalot Jr.**, Marathon Oil; **Ed Breen**, Tyco; **David Speer**, Illinois Tool Works; **Bob Iger**, Disney; **Sam Allen**, Deere; **John Hess**, Hess; **Klaus Kleinfeld**, Alcoa; **Bob Stevens**, Lockheed Martin; **FOURTH ROW: Rich Meelia**, Covidien; **Dean Scarborough**, Avery Dennison; **George Buckley**, 3M; **Daniel DiMicco**, Nucor; **John Donahoe**, eBay; **Michael Strianese**, L-3 Communications; **Ellen Kullman**, DuPont; **Ronald Hermance**, Hudson City Bancorp; **Rich Templeton**, Texas Instruments; **FIFTH ROW: Alan Boeckmann**, Fluor; **Jen-Hsun Huang**, Nvidia; **William Sullivan**, Agilent Technologies; **Greg Brown**, Motorola; **Jim McNerney**, Boeing; **Michael McGavick**, XL Group; **Scott McGregor**, Broadcom; **Frederick Waddell**, Northern Trust; **David Mackay**, Kellogg; **SIXTH ROW: John Brock**, Coca-Cola Enterprises; **George Paz**, Express Scripts; **Robert Parkinson**, Baxter International; **Shantanu Narayen**, Adobe; **Charles Davidson**, Noble Energy; **John Pinkerton**, Range Resources; **Gregory Boyce**, Peabody Energy; **Kevin Mansell**, Kohl's; **Richard Davis**, U.S. Bancorp; **SEVENTH ROW: Michael McCallister**, Humana; **Timothy Ring**, C.R. Bard; **John Strangfeld**, Prudential; **Eric Wiseman**, VF Corp.; **Theodore Craver**, Edison International; **David Cordani**, Cigna; **Chad Deaton**, Baker Hughes; **John Surma**, United States Steel; **Charles Moorman**, Norfolk Southern

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***"Anyone who calls themselves a tax-efficient or tax-aware money manager uses loss harvesting as their base," says Robert N. Gordon, president of Twenty-First Securities, a brokerage that specializes in tax-efficient investment strategies***

6

## The Bountiful Loss

**An investor has capital-gains income from a sold-off stock position. Separately, the investor has other shares that are down an equal amount; if he sold them he'd realize a loss to offset the gains and pay no taxes. But no one likes to sell low. So he wants to use that loss without actually selling the shares. IRS rules prohibit investors from taking a loss against a gain and then buying the shares back within 30 days.**

1. At least 31 days before the planned sale, the investor buys an equal value of additional shares of the underwater stock.

2. The investor buys a "put" option on the new shares at their current price, and sells a "call" option. Now he's protected from the downside on that second purchase.

3. At least 31 days later, the investor sells the first block of underwater shares. He now has his tax loss, without having taken any additional downside risk from the purchase of the second block of shares.

7

## The Friendly Partner

**An investor owns a piece of income-producing real estate worth $100 million. It's fully depreciated, so the tax basis is zero. That means a potential (and unacceptable) $15 million capital-gains tax.**

1. Instead of an outright sale, the owner forms a partnership with a buyer.

2. The owner contributes the real estate to the partnership. The buyer contributes cash or other property.

3. The partnership borrows $95 million from a bank using the property as collateral. (The seller must retain some interest in the partnership, hence the extra $5 million.)

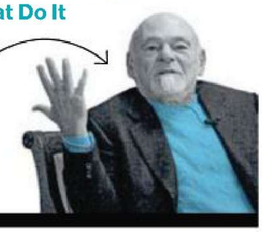
4. The partnership distributes the $95 million in cash to the seller.

**Note**

The $95 million is viewed as a loan secured by the property contributed by the seller instead of proceeds from a sale. For tax purposes, the seller is not technically a seller, and so any potential tax bill is deferred.

**Executives Who Run Companies That Do It**

Tribune, chaired by **Sam Zell,** carried out a version of these transactions in 2008 and 2009.

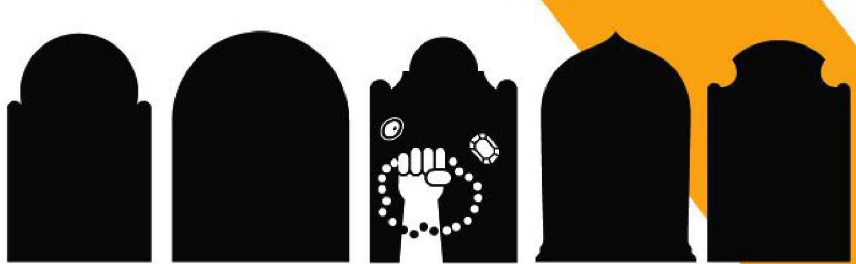


8

## The Big Payback

**A billionaire wants to invest but doesn't need the returns any time soon and wants to avoid the tax on the profits.**

A world of tax-beating products is available through the insurance industry. Many types of so-called permanent life insurance—including whole life, universal life, and variable universal life insurance—combine a death benefit with an investment vehicle. The returns and the death benefit are free of income tax. If the policy is owned by a certain type of trust, the estate tax can be avoided as well. "It is a crucial piece of any high-net-worth tax planning in my experience," says Michael D. Weinberg, president of an insurance firm that specializes in planning for high-net-worth individuals.

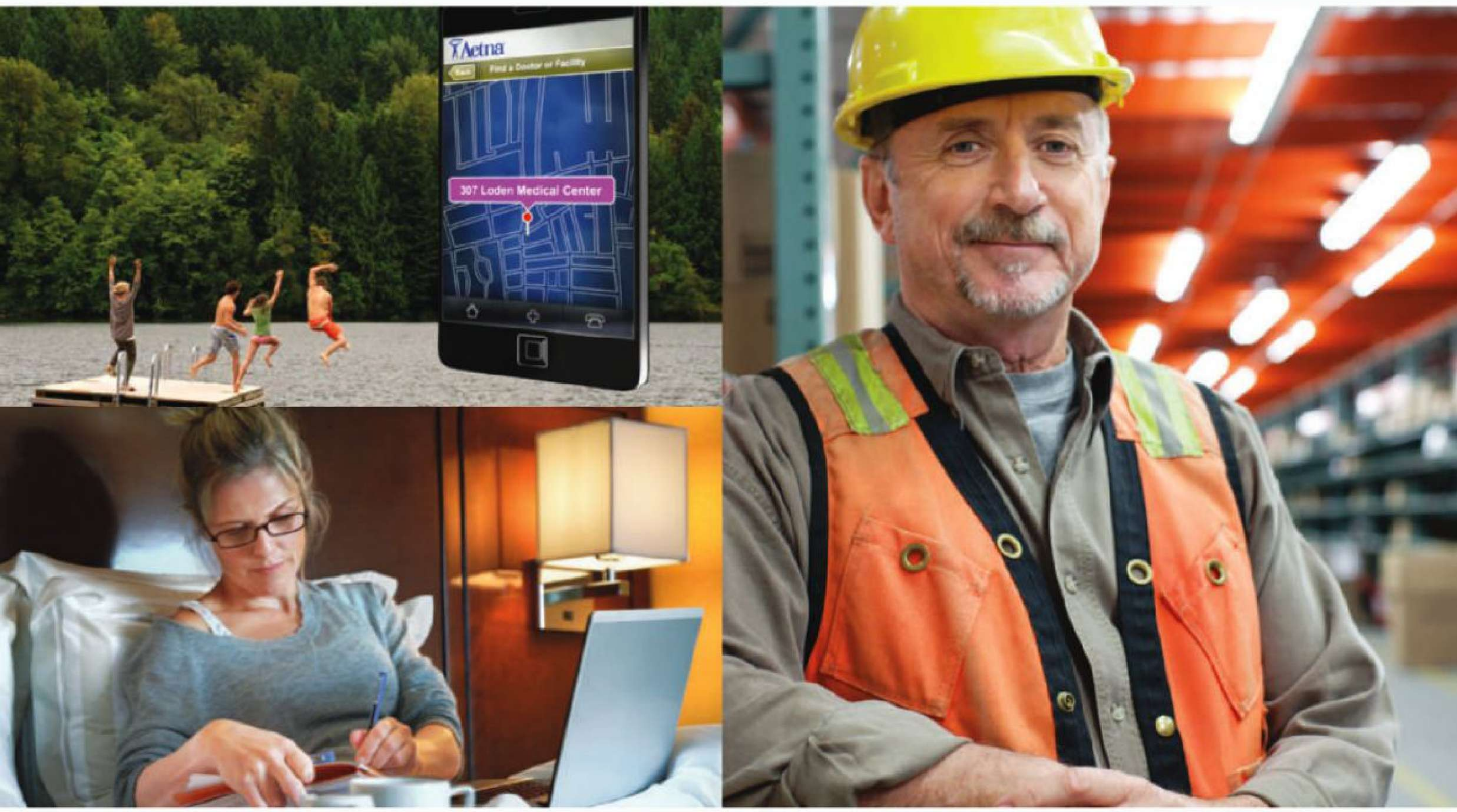


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9

# IRA Monte Carlo

**High-income taxpayers can now convert traditional IRAs, which allow contributions to be deducted from taxes but incur taxes on distributions, into Roth IRAs, where the contributions are taxed but the distributions are tax-free. The conversion triggers a one-time tax bill based on the value of the newly converted Roth IRA. As one might expect, tax experts are recommending that high-net-worth individuals convert their traditional IRAs to Roth IRAs before 2013, when ordinary income rates are likely to go up.**

1. Let's say an investor has one traditional IRA with a value of $4 million.

2. The traditional IRA is split up into four traditional IRAs, each worth $1 million.

3. The investor converts all four to Roth IRAs at the beginning of the year.

4. The IRS effectively allows taxpayers to undo the conversion for up to 21 months. So in 21 months the investor looks at the performance of the IRAs. Say two of them go up from $1 million to $2 million and two drop from $1 million to zero. Because the IRAs were split into four, the investor can change her mind on the two that went down and revert those back to traditional IRAs. Thus, she owes taxes on only the two contributions that went up in value, and nothing on the two that went down, cutting her tax bill in half. This lops 21 months of risk off the bet that paying taxes now will be paid off with tax-free appreciation later.








Starbucks CEO
**Howard Schultz**

Verizon CEO
**Ivan G. Seidenberg**

Executives Who Do It

10

# The Venti

**Executives want generous pay but don't want immediate tax bills from salaries or cash bonuses.**

Instead, they elect to set aside a portion of their pay into a deferred compensation plan. Such plans allow the compensation, plus earnings, to grow tax-deferred, potentially for decades. Starbucks Chief Executive Officer Howard Schultz had about $88 million in his plan as of the end of 2010, Securities and Exchange Commission filings show. Verizon's CEO, Ivan G. Seidenberg, had $62 million. Richard B. Handler, CEO of Jefferies Group, had $225 million. It's their money, they just haven't paid taxes on it yet.

11

# The Exit Strategy*

***not CPA-recommended**

**A parent has tons of money, and kids who might enjoy it.**

Heirs to billionaires who shuffled off into the hereafter in 2010 enjoyed one small privilege for their sorrow: There was no estate tax in 2010.

Executives Who Departed



**George Steinbrenner,** 80

**Dan L. Duncan,** 77

**Roger Milliken,** 95

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# Richard Beckman, Mini-Mogul

Once a hard-charging Condé Nast publishing lord, the man they call Mad Dog is trying to recapture his glory by pouring cash into a chain of struggling trade magazines.

By Andrew Goldman. Photograph by Marco Grob

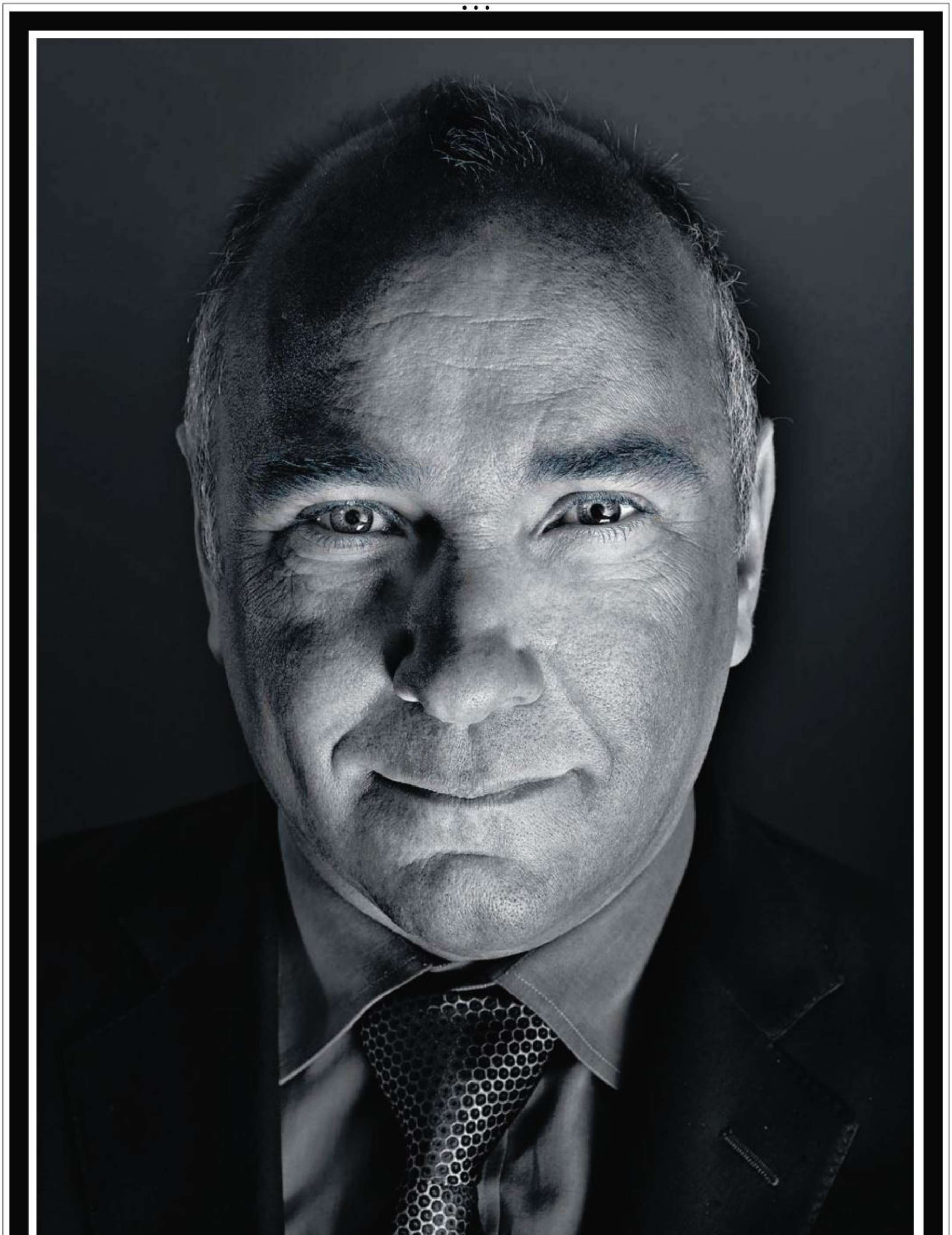


Richard Beckman says he's not particularly fond of Mad Dog, a nickname he earned as a sales executive at Condé Nast, the magazine publisher where he spent 24 years. He finds it demeaning, and says it is belied by the fact that he is actually shy and quiet. In several meetings, he does display an almost theatrical delicacy in the way he speaks and gestures, rotating his wrists in the florid manner of a magician. But there is a note of canine aggression in his voice when he calls from Aspen on Friday, Mar. 18. He is supposed to be on vacation, skiing with his family, but instead he's spent the day in crisis mode, his ear attached to his cell phone talking to his editors, magazine publishers, and his company's publicist. The *New York Post* has just printed a story declaring that investors in Beckman's one-year-old company, Prometheus Global Media, which owns *The Hollywood Reporter*, *Adweek*, *Billboard*, and other trade magazines, are scrambling to get out of their investment. For a man trying to reinvent an Old Media business, the last thing you want to read is that when your company forked over $70 million for eight publications in 2009, it "overpaid"—even when it's coming from an unnamed source in a newspaper that isn't necessarily known for its accuracy. Since Beckman and the investment partners issued firm public denials to the *Post*, who could the source possibly be? "I have no idea," he says, "but I'd love to wring their neck if I could find out."

The English-born Beckman is an archetype from a period that may never return, if it ever really existed: a salesman who made money fall from the sky during glossy magazines' heyday, accustomed to living high and celebrating his rough edges, if not his nickname. For decades he was among those responsible for turning magazines such as *Vanity Fair*, *GQ*, and *Vogue* into cash machines for Condé Nast, which publishes those titles and a long list of others. Now, Beckman has moved on from that magazine empire's glamorous Times Square cocoon of Town Cars and expense accounts and spends his days in far more modest offices downtown. (After suffering through a brutal ad recession, Condé Nast has moved on, too.) With Prometheus, Beckman is trying to repeat his success within the least glamorous sector of publishing—trade magazines—at a time when print has practically been given up for dead in some quarters. Not only is $70 million of other people's money at stake; so, it seems, is Beckman's reputation and the sense that he can be a successful visionary on his own.

"I really want to make a mark, but don't feel I have to the degree that I'd like to," he says. "I can look at myself and know I'm a good person, but there are things I'd like to achieve that I haven't yet." He has been bruised by stories like one particularly nasty column that ran in *The New York Observer* last year, which posited that he was an "irrelevant" figure at Condé Nast whose departure prompted "parties in the hallways," and by more recent blog posts suggesting his new venture is hemorrhaging money. For someone who's been called a bully, Beckman has a surprisingly fragile ego. "I couldn't bring myself to read it," he says of the *Observer* piece. "I was so upset."

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Beckman and Friends ... Mariah Carey and Nick Cannon; Mary J. Blige and Usher; Chris Brown; Justin Timberlake; Bono

"I'm a fierce competitor," he continues. "I can tell you, no matter how many caustic articles that they write about me or my team or these businesses, that we will prevail and it will be at their expense."

B-to-I," Beckman says with a twinkle-eyed smile. "I should have trademarked that."

Beckman is in full salesman mode. Rather than running a business that primarily services consumers, such as *Vanity Fair*, or a media business that services another business, such as *Variety*, Beckman claims he's invented a new category of audience. "Business-to-influencer means your product is talking to not just the industry but also to that top-of-the-pyramid consumer who follows those industries," he says. It's a pitch he's promoting in a highly produced video for potential advertisers, featuring actors and movie producers whose names I must promise not to disclose, who wax on about the massive cultural influence of Hollywood and how *The Hollywood Reporter* is synonymous with that influence.

The B-to-I pitch is meant to entice consumer advertisers that otherwise would never consider buying ads in such a low-circulation publication. After Prometheus bought *The Hollywood Reporter*, paid circulation of the daily was reported by BPA Worldwide to be just over 12,000. Since relaunching it as a weekly, Beckman says circulation is 72,000, but he refuses to disclose the breakdown of paid vs. free subscriptions. These 72,000 people—the influencers—are pretty much the best 72,000 people any advertiser could dream of reaching, he says. While most of Beckman's energy has been focused on *The Hollywood Reporter* thus far, he hopes to apply his approach to Prometheus's other publications as well.

Printers' ink runs through the veins of all four men who in 2009 sought to buy *The Hollywood Reporter* and seven other barely profitable publications, including *Billboard*, *Adweek*, *Brandweek*, and *Mediaweek*, from Nielsen. The deal's mastermind was James "Jimmy" Finkelstein, the chairman of News Communications, which owns the paid biographical listing service Marquis Who's Who. Finkelstein also owns the Washington-based political paper *The Hill*, begun by his father, Jerry, who also owned *The New York Law Journal*. Jimmy Finkelstein is also chairman of Pluribus Capital, which he formed in 2009 to buy media properties.

Joining Finkelstein at Pluribus was George Green, a former chief executive officer of *The New Yorker* and longtime president of Hearst Magazines International. The third member of the Pluribus troika, Matthew Doull, started his career as a cub reporter at London's *Telegraph*, owned at the time by his step-uncle, the fallen media baron Conrad Black. Doull eventually joined the business side of Black's company running its investing arm, Hollinger Capital. In mid-2009, Finkelstein discovered that Nielsen was interested in selling its business media properties in advance of an initial public offering. Along with Green and Doull, he prepared to make an offer. In addition, a critical member of the team was Lachlan Murdoch, the eldest son of Rupert. After leaving his father's company, News Corp., in 2005, Murdoch had founded Illyria, a private equity firm that invested almost exclusively in Australian media companies. According to a person familiar with the negotiations, Murdoch and Finkelstein's Pluribus were planning to share the burden of financing the $70 million price tag equally. Murdoch did not respond to requests for comment.

Beckman, meanwhile, was plotting his departure from Condé Nast. He had recently become president of its Fairchild Fashion Group division, a $75 million unit that included fashion magazine *W*, as well as trade magazines such as *Women's Wear Daily* and *Footwear News*. It had been underperforming, and Beckman's assignment was seen as a mandate to fix a broken business. He also began having discussions with Todd Boehly, managing partner of investment firm Guggenheim Partners, which has been headed by former Bear Stearns CEO Alan Schwartz since 2009. Beckman and Boehly hatched a plan to buy Fairchild from Condé Nast Chairman Si Newhouse, but Newhouse wasn't interested in parting with the company for an amount that wouldn't come close to the $650 million he'd paid to buy it from Disney a decade earlier.

In late 2009, not long after those discussions fell apart, Murdoch backed out of the Nielsen purchase. Beckman, who says he and Boehly had been looking at Nielsen independently, heard that Finkelstein's team was interested, too. Pluribus had a deal in place but needed money, and Guggenheim had billions and wanted media properties. "I brokered that marriage a little bit," Beckman says. In December 2009 it became official.

As much as Beckman likes to say he wishes he'd trademarked B-to-I, influencer is a well-traveled marketing buzzword. Beckman unveiled his version at a big presentation to Fairchild's staff, where he laid out how the company would be retooling its products beyond business-to-business and into a realm where influencers who loved fashion would be targeted alongside people wheeling clothing racks through the garment district. It was a slick pitch, but one that seemed oddly out of sync for most of Fairchild's titles.

Of course, Beckman's Fairchild plans proved moot. He left to become the head of Prometheus, which was initially called e5 Global Media. In May 2010 he shocked the reces-



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... Carlos Santana; Alicia Keys; Jennifer Lopez; Fergie and Josh Duhamel

sion-battered media industry when he announced that he'd hired Janice Min, who had made a seven-figure salary in her previous job as editor of *Us Weekly*, to be the editorial director of *The Hollywood Reporter*. Min would be turning the *Reporter* into a weekly, and Beckman proclaimed he would lure beauty, fashion, consumer electronics, and liquor ads into the publication for the first time. The design firm Razorfish was brought in to revamp the website. The staff of 45 grew to 65.

Then Beckman approached *Vanity Fair* columnist Michael Wolff about taking over *Adweek*. While most magazines were laying people off in droves, Beckman was spending like it was 1999. "I said, 'I don't think you can afford me, Richard,'" Wolff recalls. "And it turned out that he could afford me. He offered that ineffable combination of flattery and money." Beckman told Wolff he wanted to invest in a thorough overhauling of *Adweek*, which had been making about $2 million a year, according to a member of its previous management. (Beckman evidently overlooked the fact that his new editor is also the author of *Burn Rate: How I Survived the Gold Rush Years of the Internet*, an account of reckless venture capital spending in the 1990s—including his own.)

*Adweek* will relaunch later this month with a bulked-up staff. The business model it will emulate is that of Politico, a privately-owned product that is primarily known for the political news it breaks on its website, but believed to be profitable because of its small-circulation daily print version, which is full of expensive ads from lobbyists and other companies that hope to reach the influential Washingtonians who receive it. Wolff hopes Adweek.com will become the go-to site for media news and that the extensive reporting manpower required will be paid for by ads in a much smaller-circulation weekly magazine (which, unlike Politico, which is distributed free, costs $299 for print and digital access, according to its website).

As well as making big hires, Beckman made a few formidable enemies. Before Beckman settled on Min, Doull approached Sharon Waxman, editor of the website TheWrap, about *The Hollywood Reporter* job. Boehly also conducted extensive talks about the position with Nikki Finke, the famously reclusive and feared editor of Deadline|Hollywood, a movie industry site. In March, news that Finke had been offered the job made it onto Waxman's website. Most people in Hollywood do their best to avoid Finke's wrath. Beckman, however, chose to issue a statement that there was "no truth to the report" of the job offer. On her blog, Finke said she'd been offered a $450,000 salary, an estimated $650,000 a year for a share of anticipated cable TV deals, and a $1 million Malibu condo. Boehly doesn't deny that such a conversation took place but parses the meaning of the word "offer." "When you're in the deal business like I am, an offer is very formal and very rigid," he says, adding, "When you're in kindergarten and you're trying to make friends with someone and someone asks you, 'Can you help me with my homework assignment' and you say, 'O.K., I'll consider it,' is that an offer?" Finke declined to comment for the record.

After angering his new industry's two most prominent bloggers, Beckman then proceeded to insult his new staff in an interview with *The New York Times* by demeaning the work of *The Hollywood Reporter* employees inherited by Prometheus. "It's our negligence—the way we served up our content over the last couple years has allowed some really poor competitors to emerge," he said. "But we're going to rectify that starting right now." In another interview he took a shot at one of those rivals: "If I'm setting the bar where *Variety* is—and this is going to sound really caustic—I'm setting the bar too low." It was like moving into an unfamiliar Hollywood neighborhood and cranking up a dozen leaf blowers.

With a thud, Beckman plunks down the first issue of the redesigned *Hollywood Reporter*. It's November, and the magazine just hit newsstands. It looks expensive. It features a glossy Vanity Fair-like cover featuring a group of actresses including Natalie Portman and Nicole Kidman. But the real point of pride for Beckman has to be that it is 156 pages thick with 67 pages of advertisements. Along with the ads that have long been the bread and butter of the trades, such as the page HBO bought to congratulate Laura Dern, Diane Lane, and Bruce Dern for their Hollywood Walk of Fame stars, there are consumer advertisements that have rarely been seen in either *The Hollywood Reporter* or *Variety*: Versace, Citibank, Lancôme, Möet.

Over courses of prosciutto and cheese, roasted chicken, and Italian white wine at Da Silvano, a Manhattan restaurant, Beckman tells stories of the lost world of New York publishing and the giants of Condé Nast—men he loved and admired. Among them was Art Cooper, *GQ*'s legendary editor-in-chief and practitioner of the good life, who loved to smoke and enjoyed heavy, boozy business lunches—and who dropped dead in the middle of one such lunch at the Four Seasons in 2003, a few months after retiring. As publisher of *GQ* from 1995-'98, Beckman helped turn it into a publication whose ad-stuffed girth rivaled that of Condé Nast's perennial cash cow, *Vogue*.

He loved Steve Florio more than anyone. The former Condé Nast CEO imported Beckman from the London office and made him his protégé. Florio had been the

founder of the annual "Italian guys" lunch—Condé Nast's clique of bespoke-suited, tough-talking ad sales executives such as Ron "Mr. Big" Galotti and Florio's brother Tom. Beckman, who grew up Jewish in middle-class northwest London, the son of an accountant and schoolteacher, was judged close enough to be made an honorary "Italian guy" and was given a seat at the table. (The final Italian guys lunch was held in early 2008—at Da Silvano—just a few months after Florio died of a heart attack. Only 58, he had been relieved of his CEO job three years before.)

Beckman eventually became president of Condé Nast Media Group, a department that superseded the magazines' publishers and sold ad pages directly to the biggest advertisers, those with budgets to advertise across most or all of the Condé Nast titles. As a testament to his value, Beckman had been given the job even after a highly publicized incident in 1999: During a booze-soaked sales meeting in Los Angeles when he was publisher of *Vogue*, he'd forcefully encouraged one female advertising executive to kiss the magazine's international editor. The two women collided, and the sales executive was injured badly enough that she told Condé Nast she required surgery and claimed the incident was part of "a pattern of questionable behavior" by Beckman. Condé Nast settled for more than $1 million and issued a statement saying Beckman "acknowledges some inappropriate behavior on his part and is seeking counseling to address that issue." Because of the settlement, Beckman can't talk about the incident.

It was in his position leading Condé Nast corporate that Beckman solidified his status as someone not to be trifled with. He developed a reputation for yelling at employees and for executing petty power plays, such as making his staff wait for him for hours. "He's nuts, he's fun, and he's extremely, extremely aggressive," says David Penski, the president of ad-buying agency ZenithOptimedia, who negotiated with Beckman on behalf of a number of advertising clients over the years. "He has a very large ego and he wants things done his way, period." Says Beckman's friend L.A. Reid, former head of Island Def Jam records: "He's awfully charismatic, but I've also seen Richard get upset, with, like, smoke coming out of his ears."

Advertisers liked him and feared him. "There are very few people who can call any single agency president and get a meeting in five minutes," Penski says. "He's one of them." As ad dollars began migrating to the Internet in the mid-2000s and other magazines began dropping their print ad rates, Beckman insisted on raising rates every year. Advertisers had no choice but to pay; in terms of reaching large numbers of well-heeled consumers, no other publisher could touch Condé Nast. "There was that underlying feeling that if you were a luxury brand and you stopped advertising in Condé Nast books, that was going to hurt you from an editorial perspective," says Penski, who cites no examples. For the Chanels of the world, Beckman was unavoidable, like the ferryman at the River Styx. Condé Nast did not respond to a request for comment. Says Beckman: "Condé Nast always operated with a church and state philosophy, that we would never allow commercial support to influence editorial coverage."



Late GQ editor Art Cooper; Condé Nast Chairman Si Newhouse; late Condé Nast CEO Steven Florio; *Hollywood Reporter* Editorial Director Janice Min; Michael Wolff, head of *Adweek*

He remained in his perch for eight years, longer than any who'd held the position before. Yet as much power as he had, Beckman felt stymied in his efforts to influence operations, telling friends he felt that Newhouse and Condé Nast had been shortsighted in relying entirely on the sale of print ads, a business vulnerable to recession. The financial meltdown of 2008 vindicated those fears. It crushed the advertising market, and for the first time in memory, Condé Nast lost money.

Beckman had never made a secret of his desire to be CEO. "That company believed in me before I believed in myself, and I was very proud of everything I achieved there," he says. "But in my last year or two there was a real sense for me that I thought my job at that company was done. And Chuck [Townsend, the CEO] wasn't going anywhere." Beckman landed at Fairchild, and in a further blow to his ego, the press treated his new job as a huge demotion. In the wake of the financial meltdown, the company also canceled his real pride and joy—the multimedia extravaganza that he had dreamed up, Fashion Rocks. He was about to turn 50. His mother was dying of cancer. It was in this battered headspace that he set out for Prometheus.

It takes months before Beckman's schedule allows for a long-promised whiteboard presentation of Prometheus's master plan. The company's Broadway offices have dingy, pockmarked walls and a pile of old, broken computers lying in a hallway. Beckman's office is by comparison the retreat of a pasha: dark wooden Venetian blinds, overstuffed leather chairs, a marble desktop, a blue guitar given to him by Carlos Santana mounted on the wall, and a large bronze sculpture of a knight on horseback, a gift from his wife, Kristen, when he became publisher of *Vogue* in 1998. "I'm obsessed with knights," he says. "They were the most fierce warriors, right? But they had an incredible code of integrity, chivalry." Beckman, who travels frequently, is not seen by employees in the office very much. You can tell he's in when classic rock such as David Bowie and Queen's *Under Pressure* is blaring.

No whiteboard is in evidence. There is, however, a 60-inch plasma screen tuned to soccer with the sound down. Beckman seems unable to concentrate. Mid-conversation, he keeps trailing off as his eyes settle on the game. His favorite team, the Tottenham Spurs, is minutes from winning, the first time they've been in contention to take the European Cup, but his eyes look despondent. "I'm really upset about the call I just had," he explains. He'd been at the Grammys over the weekend, he says, trying to per-

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> "The product's pretty good," says Bob Dowling. "But you can always come up with something that's fantastic as long as somebody else is paying for it"

suade an unnamed artist to perform at the Billboard Music Awards, the struggling program he now owns and hopes to reinvigorate on May 22 in Las Vegas. ABC will broadcast the show, and he has booked premier acts such as The Black Eyed Peas, Rihanna, and Jennifer Lopez—but apparently they are not enough.

The bookings are killing him: "When a client tells you if you do this, this, this, this, and this, and you do all they ask, you walk through a burning building, and you have a conference call set up on the Tuesday just to tell them how happy you are you're able to achieve all these things. Then they say they changed their mind." He stops, shakes his head. "It's just not what I would regard as integrity in business dealings, and it pisses you off." Beckman admits he's prone to black moods, feelings of intense self-doubt. "I probably have imposter syndrome, thinking I have people fooled. It's probably what drives me," he says. "Oh, my God. Living inside my own head is tough. I'm a tortured soul."

*The Hollywood Reporter* has been embraced by the Hollywood community. "The product's pretty good," says Bob Dowling, a former publisher of *The Hollywood Reporter*, who oversaw one of its most lucrative periods, from 1988 to 2005. "But you can always come up with something that's fantastic as long as somebody else is paying for it forever. "

The Mar. 25 issue is a good-looking, 64 glossy pages, but it's a far cry from the premier issue. The first ad on the inside cover is a house ad for Prometheus's new Reality Rocks Expo, a trade show for people who want to make or appear in reality TV shows. The 15 pages of other ads are almost all so-called endemic ads, various entities wishing Bryan Adams congratulations on the Hollywood Walk of Fame and so forth. The "beauty, fashion, consumer electronics, and liquor" ads that Beckman promised and had in the first issues are nowhere to be seen. "He got them to begin with because everyone owed him a favor," says Penski. "And I think that he's struggling as these companies are struggling, too."

Dowling finds Beckman's notion that there's something novel about a trade publication trying to lure consumer advertising amusing. "You honestly think that we didn't think of that?" he says. "*The Hollywood Reporter* had a monthly magazine in the mid-'80s. Guess what they were trying to do? Get consumer advertising. That didn't work. There was *V Life*, that didn't work. There was *Premiere Magazine*, that didn't work. There was *American Film Monthly*, that didn't work. Why? No advertising." Beckman has never heard of Dowling, but when confronted with his logic, he counters with his B-to-I argument. "Our magazine provides access to the most influential constituent in the entertainment space," he says. He says that *THR* has broken even on every issue, advertising is up 50 percent since the launch, and that Web traffic has ballooned more than 800 percent since he took over. "Overall, I'm very pleased with the first 15 months," he says. "But no one is popping the champagne corks. We've got a lot of wood to chop, a lot of things to do."

When Beckman finally presents his whiteboard, which has been jammed into his office, it is filled with grand ideas to take dusty but great brands and launch them into the stratosphere. There's an *Adweek* reality show, a *Billboard*-branded partnership with MySpace for unsigned bands, a DirecTV-based Billboard Music Channel. Beckman says there are serious talks for a *Hollywood Reporter* edition for Bollywood. "I was just back from New Delhi," he says. "I was on the phone before you came in with a principal of one of the larger media companies over there. We are interested in taking the global influence of the entertainment industry to other countries."

A person familiar with the finances of the operation estimates that Prometheus is on track to lose as much as $10 million a year. "Nonsense," Beckman says. "We were profitable in 2010, and profits will increase in 2011." Even if *The Hollywood Reporter* was losing tons, it wouldn't necessarily mean it was a failed experiment; *Vanity Fair* was initially a big money loser upon its relaunch in 1983.

The financial health of the magazines might be beside the point. "You've got to look at it from a Wall Street perspective," says Ross Johnson, a former *THR* business reporter who is now a prominent Hollywood public-relations consultant. "This is the kind of play that private equity guys love." Neil Stiles, president of Variety Inc., says he can't make Beckman's math work but also wonders if Prometheus might have less immediate motivations than turning a profit on its magazines. "What they're clearly about is asset value, not P&L," Stiles says. "That's the stunning thing about private equity. You don't actually have to make a profit, you just have to look like you might one day, and then you sell to another private equity firm. It's sort of like a Pass the Parcel game at a children's birthday party, but instead of passing a nice present, you're passing an explosive device. The last private equity firm ends up getting their face blown off."

Whatever happens, Beckman is clearly a man who wants his story not to end with Condé Nast and all that happened there. Auspiciously, Prometheus is named not only for the Greek god who brought men fire but also had his liver eaten over and over again by a giant eagle while chained to a rock—Beckman is a man who places great value in symbols. He's wearing the same silver bulldog cuff links today that he wore at our last meeting, which makes me wonder if he's really that opposed to the Mad Dog label. He shakes his head, and says they're in honor of his 6-year-old son's beloved stuffed animal. "When we were shopping once, he saw these cuff links and he said, 'Daddy, Dog-Dog cuff links.' So I bought them." Is Mad Dog really such a bad nickname? "Some people say I should embrace the dog," he says. "But it's not pleasant, the way some people articulate it. It's related to my tenacity and my persistence, but I also would like to think it relates to my loyalty. I spent 24 years at Condé Nast. This is only the third job of my life." B



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# THE MEGA BUS EFFECT

**WHY ARE SO MANY PEOPLE CLIMBING ABOARD CURBSIDE BUSES?**

BY BEN AUSTEN

PHOTOGRAPHS BY ANDREW HETHERINGTON

"We're trying to get people out of their cars," says Coach USA CEO Moser

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On a Chicago morning in late December, 60 people are lined up outside along a downtown street, waiting for buses headed to Des Moines, Indianapolis, and Kansas City. It's 20F, the wind talons, and the travelers sway and stamp. A student of clinical psychology at the University of Illinois at Chicago, standing near four dreadlocked white guys, says he paid $26 for a 200-mile trip to Iowa City, which prompts someone else to brag that his seat on the same double-decker bus cost $5.

They're all there to catch rides offered by Megabus, the largest of the private companies to corporatize New York's "Chinatown bus" model of street-side pickup, express travel between sizable cities, and cut-rate fares. Half a mile from the Greyhound depot and barely on the periphery of Union Station's Beaux Arts grandeur, the Megabus stop's only identification is a modest street sign displaying the company name above its mascot, a cherubic, Benny Hill-like character in a yellow driver's cap.

After the Des Moines bus departs, a dispatcher shouts that Indianapolis-bound travelers can sit on the "warming bus." He points to a white coach idling 50 feet up the street. The crowd migrates that way, leaving on the sidewalk Dale Moser, chief executive officer of Megabus's parent company, Coach USA. Bundled only in a thin leather jacket and earmuffs, Moser, 55, says he has been watching the operations for more than an hour. He immediately begins detailing the company's merits: how 90 percent of customers book online, many simply showing tickets texted to their phones to board; how the buses all offer free Wi-Fi and power outlets at every seat; how every trip includes at least one $1 fare, with prices going up as the departure date nears and as the bus fills; how there are no terminals or storefronts, just a bare-bones back-office staff; how the bus fleet is in constant use. "You cut all that overhead out of your business, you find you can pass that savings on to customers, thus driving volume," Moser says. About once a month he rides the buses himself, as a sort of secret shopper, chatting people up and asking about their travel experiences. "If they look at me like I'm a real creeper, I tell them who I am," he says.

When the ink in my pen freezes, I ask if he would mind continuing our conversation inside. The head of the biggest "curbside bus" carrier—a mode of transportation that is by far the fastest-growing in the nation—surveys his teeming Chicago hub. He suggests the Dunkin' Donuts across the street.

**Megabus and Coach USA are owned** by the British company Stagecoach Group, and they have fundamentally changed the way Americans—especially the young—travel, so much so that they may help kill plans for new railroads.

THE MEGABUS APPROACH WORKS SO WELL, IT MAY SCUTTLE PLANS FOR HIGH-SPEED RAIL

In 2010, Megabus launched its third and fourth hubs, in Philadelphia and Washington. It currently does $100 million in business annually, operating 135 buses each day to 50 U.S. cities. While other companies downsized over the past two years, Megabus hired 270 additional workers and invested $36 million in the business. Each month this year it will add five to six new double-deckers to its fleet.

Appearances to the contrary, Megabus and the other major curbside bus companies contend that their model has little to do with the Chinatown carriers. The difference may be a matter of scale. Fung Wah, for instance, still makes 24 trips daily from New York to Boston, its only route. Megabus began with nonstop service from Chicago to seven Midwestern cities, all with populations of around 1 million, and has grown from there.

About the business model's undeniable similarities to the Chinatown buses, Moser says: "We're nothing like them, except for the curbside." (Fung Wah Transportation declined to comment.) Why Megabus and others distance themselves from the noncorporate carriers became even more apparent in March, when a charter bus returning to New York's Chinatown from the Mohegan Sun casino in Uncasville, Conn., flipped on I-95 in New York and was sheared in two, killing 15. Just days later a bus serving mostly Chinese immigrants ran off the New Jersey Turnpike, killing the driver and a passenger. Suddenly there were calls to investigate the practices of all discount bus companies. "There's a perception that we're a cheap company," says Moser. "But to provide low-cost service, we don't cut corners on safety. Safety is our top priority."

Last September four passengers died when a Megabus driver missed an exit and crashed near Syracuse, N.Y. But the company still maintains the top rating from the Federal Motor Carrier Safety Administra-

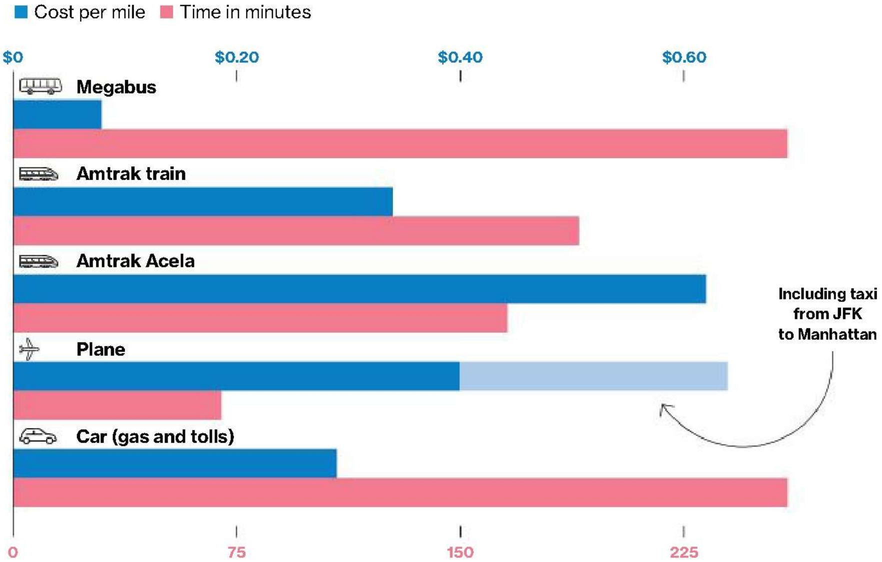


Megabus customers waiting to board in Chicago



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**Although buses lack the speed of planes and the privacy of cars, they are clearly more cost-effective, at 8¢ per mile on a trip from Washington, D.C., to New York. And Wi-Fi service means the extra time can be used productively.**




NOTE: COSTS REFLECT THE LEAST EXPENSIVE TICKET AVAILABLE ON MAR. 7 WITHIN ONE HOUR OF 9 A.M. FOR TRAVEL ON MAR. 25 GAS COST BASED ON 24 MPG @ $3.68 PER GALLON TOLLS: $30.05 DATA: BLOOMBERG

tion. And Moser stresses that being part of a large, international corporation means there's the wherewithal to implement rigorous safety standards that include driver training; rules regarding the length of work shifts and the frequency of rest stops; GPS monitoring of all buses to ensure they're on course and away from low overpasses; and on every bus purchased since 2006, seat belts for passengers—something the law does not require.

In Britain, the publicly traded Stagecoach Group is a transportation monolith, moving 2.5 million people each day on its buses and a full quarter of all U.K. rail passengers on its commuter lines and trams. The company first tried the Megabus idea there in 2003, and the service now links 50 cities in England, Scotland, and Wales—and hooks up with Megatrain—with fares starting at, yes, £1. The company's American division, Coach USA, operates charter, sightseeing, and even school buses throughout the U.S. and Canada.

Surprisingly, the initial expectations for Megabus in the U.S. were low. At the 2006 kickoff party, held at Chicago's Navy Pier, Moser's boss, a Scotsman, asked the Pennsylvania native to assess their prospects. "I told him, 'We're Americans, we're attached to our cars. That's our identity. It's going to be a challenge, but let's give it a shot,'" Moser recalls as we sit in the Dunkin' Donuts, watching his buses pull up along the opposite curb and depart.

Gas prices soared, however, and ridership rose along with them. Within six months officials from other Midwestern cities were offering Megabus prime pickup locations and help with promotions if only it would, please, include them on a route. In 2008, Greyhound and Peter Pan formed BoltBus, which says it turned a profit after only three months of service between Northeast Corridor cities. After startup it took Megabus a mere two years to move 2 million passengers to and from New York, and on all its U.S. routes it now handles about 4 million passengers annually.

For bus travel as a whole, the number of daily departures increased by 6 percent in 2010, twice the growth experienced by air travel and 12 times that of Amtrak. The number of curbside passengers rose by at least 33 percent, with Megabus ridership expanding 48 percent. (Amtrak ridership grew by just 6 percent, and the airlines by 5 percent.) The company says growth, including the 20 routes it added last year, is an astounding 65 percent. Curbside buses now account for more than a fifth of all daily bus departures in the country. The American Bus Assn. maintains that traditional intercity bus service on Greyhound, Trailways, and others has even experienced a positive spillover—the group calls it "the Megabus effect."

**There's a battle going on to control the** in-between routes, the 200- to 300-milers. Air travel, despite its enormous carbon footprint (and meager profitability), is unlikely to be displaced anytime soon as the transportation of choice for long-haul travel. For short distances, the car is still king. But of the most traveled American routes, many fall into this middle category: New York to D.C. (or Boston), Los Angeles to Las Vegas, Chicago to Detroit (or St. Louis), Dallas to Houston (or Austin or San Antonio), Miami to Orlando, Nashville to Atlanta (or Memphis). These routes are too far for a leisurely drive and too near for most Americans to justify the expense, or increasing hassle, of a plane. In 1990 a third of Americans flying domestic traveled these medium-haul distances. By 2009, though, that portion had shrunk to a quarter of all fliers.

In Europe, these are the routes owned by rail, and transit policy experts in the U.S. hope that in coming decades high-speed rail will serve that market. But it's the intercity bus, the tortoise of the transport world, that is taking over much of the medium-haul market. On most city-to-city trips under 300 miles,





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the curbside bus offers tickets that cost a tenth of those of Amtrak and far less even than the price of the gas to get there by car. The bus is also at least four times more fuel-efficient than a car. Researchers at DePaul University's Chaddick Institute for Metropolitan Development estimate that curbside carriers, at their current capacity, already reduce fuel consumption by 11 million gallons annually, the equivalent of taking 24,000 cars off the road.

Much of the recent success of the curbside business derives from its nimbleness. In February the Obama Administration unveiled some specifics of its long-term plan for high-speed rail, requesting $53 billion over the next six years to build and upgrade intercity service—a proposal that has already met opposition. By contrast, the bus simply uses existing roads, requiring no policy debates, government funding, or land management studies. It needs only a curb and a sign. Bus companies are also able to gauge demand quickly, gather rider input online, then alter pickup locations or routes just by posting changes to their websites. While we're having coffee, Moser explains that since he's seen numerous requests on transit blogs for new service from Chicago to Memphis, he figures he might as well give the route a try. A couple of weeks later he has the buses up and running.



The curbside bus can also easily add and subtract departures. During Thanksgiving and Christmas in 2010, Megabus continued to sell as many tickets as were requested on its website, adding buses as needed. In Chicago, the buses were lined up all the way around the corner at the pickup location. "It's astounding how few constraints there are to its development and expansion," says Joseph Schwieterman, the director of DePaul's Chaddick Institute. "That's why it's an exciting product to watch. Adding two big hubs in six months—we just don't see that anymore in transportation."

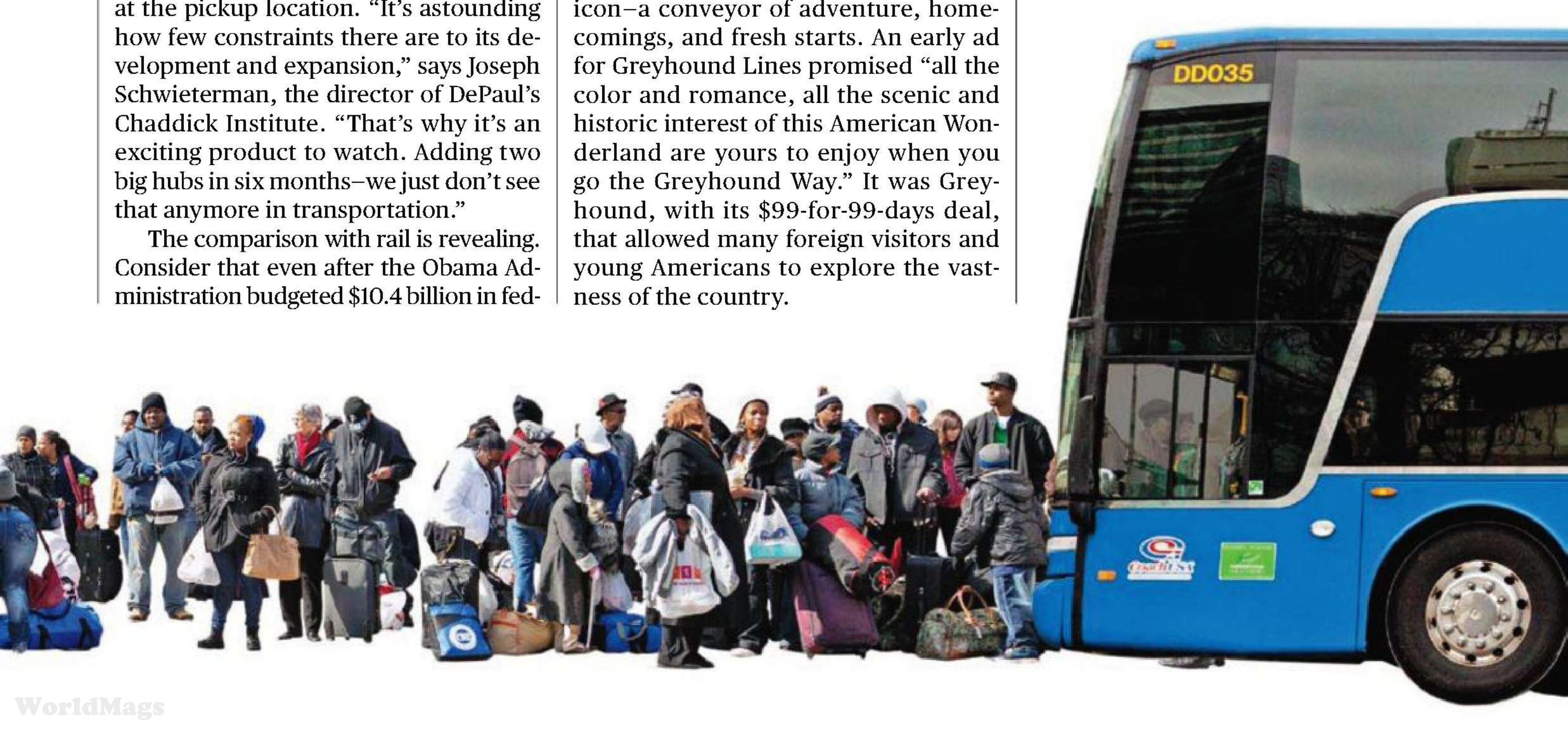
The comparison with rail is revealing. Consider that even after the Obama Administration budgeted $10.4 billion in federal stimulus money to jump-start high-speed rail projects around the country, the states had to submit proposals, federal transportation officials had to select the most viable ones, and state and federal governments had to negotiate these plans with the freight companies that own most of the nation's track. After all that, politicians, citing budget shortfalls, ended up scuttling many of the plans.

## CURBSIDE CARRIERS REDUCE FUEL CONSUMPTION BY 11 MILLION GALLONS YEARLY, RESEARCHERS SAY, EQUIVALENT TO TAKING 24,000 CARS OFF THE ROAD

**A generation and a half ago, more** than 2,000 Greyhound, Trailways, and other intercity buses crisscrossed America's roads, linking some 15,000 communities. The bus remained a national icon—a conveyor of adventure, homecomings, and fresh starts. An early ad for Greyhound Lines promised "all the color and romance, all the scenic and historic interest of this American Wonderland are yours to enjoy when you go the Greyhound Way." It was Greyhound, with its $99-for-99-days deal, that allowed many foreign visitors and young Americans to explore the vastness of the country.

Women, too, frequently traveled alone on buses. The Big Band-era ditty *Love on a Greyhound Bus* promised that a single lady riding coach, rather than being harassed or scared, might find a charming companion seated next to her: "Soon the sun disappeared from view/The stars came out as they always do/And then I cuddled up next to you." Bus travel, though, began to fade as car ownership and air travel increased, and inner cities, where the terminals were located, decayed. After 1960, ridership steadily decreased, and routes were slashed. The U.S. Government Accountability Office estimated that the number of riders dropped from 140 million in 1960 to 40 million in 1990, the year Greyhound filed for Chapter 11 bankruptcy protection—and the figure sank further over the next 16 years. By then bus travel had acquired the stigma of second-class citizenship, the transport of last resort. The back seat of a Greyhound bus was the kind of place a derelict like Ratso Rizzo, Dustin Hoffman's character in *Midnight Cowboy*, would go to die.

In the late 1990s, though, mostly secondhand buses began ferrying immigrant passengers between the Chinatowns of New York and Boston. The "Chinatown bus" quickly grew into a tangle of private companies offering dirt-cheap curbside-to-curbside express service to cities along the Northeast Corridor. It wasn't an elegant mode of travel. In those first years there were incidents of buses catching fire en route and wheels falling off on the highway, and many stifling rides without




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air conditioning and with the '80s music dubbed into Cantonese blaring overhead. Legislatures occasionally wrestled with issues of congestion around pickup locations and regulating the businesses.

Still, the buses were a hit with college students, and without advertising, name recognition, or even a Web presence, demand continued to rise. Despite four decades of steep declines in city-to-city bus travel, both the number of routes traveled and overall passengers spiked in 2006, the year Megabus hit the road.

The new bus riders are not the old ones. These days they are likely to be young, well educated, and digitally connected. Megabus says more than half its riders are aged 18 to 34. BoltBus claims three-quarters of its passengers are in that demographic and that 82 percent of riders are in college or are college graduates.

These riders are returning for additional trips in no small part because Wi-Fi-enabled buses allow them to surf the Web, write papers, and watch their own movies as they idle in traffic or barrel down the Interstate. There's even a bit of an "overheard on the bus" Web genre, as well as a Twitter complaint account named "Megabus fails." Last year researchers at Schwieterman's Chaddick Institute embarked on 235 bus, rail, and plane trips, observing 19,500 passengers to assess the frequency of portable technology use on these various modes of transportation. In a paper released in January, Schwieterman and his team reported that curbside passengers use technology at greater rates than any other riders except those on Acela Express, the premium rail service that offers a great deal more space to spread out and work in. When Schwieterman's students surveyed 200 BoltBus and Megabus travelers in New York, 92 percent said they planned to use an electronic device on their trip and 37 percent agreed that the availability of Wi-Fi and power outlets were central to their decision to travel via curbside bus.

In ways similar to neighborhood gentrification, the college kids and bohemians have settled territory that now appeals to less adventurous groups. Curbside travelers have come to include large numbers of "silver surfer" retirees, business commuters, and—once again for intercity bus travel—women riding alone. Moser says a quarter of Megabus's passengers are unaccompanied women. In surveys the company conducted before its Chicago launch, women consistently said they were excited by the prospect of not having to drive or park downtown and of visiting the city at a price that left them with more money to spend on shopping or theater or meals. But this group also proved especially averse to the idea of a bus depot. For them and others, a streetside stop transformed the bus into an entirely different mode of travel. "Would I want my daughter or my wife in a bus terminal by themselves? I'd say no," Moser says. "We're creating new bus customers and a different demographic."

Schwieterman points out that the curbside bus may be too down-market to draw business travelers or go fully mainstream. Still, he believes it could change the balance of transportation in the country if it manages to operate successfully between medium-size cities throughout the country. "Then you would see continued growth without constraint," he says. The business is already displaying the versatility needed to take this leap, and any new regulation of the industry following the recent fatal accidents would harm small competitors far more than the corporate players that can better afford compliance. Both Megabus's Moser and David Hall, who heads BoltBus, are reluctant to talk about specific expansion plans, but they agree that their business could flourish in California, Texas, Florida, and just about anywhere in the country. "We're trying to get people out of their cars," Moser says. "That's an unlimited market."

One of Schwieterman's students, Brian Izzo, describes the experience of riding curbside carriers while working on the technology study—the social atmosphere on the buses, their affordability, their connectivity. "For a young person like myself, it's an easy way to get out and explore, to see the country," he says. Originally from St. Charles, Ill., Izzo, in a year of research, has become as seasoned a traveler as most corporate lifers. I mention jokingly that it sounds like he's parroting one of the old Greyhound campaigns extolling the unbridled adventure and romance of the road.

"But it feels that way," he says with utter earnestness. "It really does." ■






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# INDIA RISING

**The world's second-most populous country is gearing up for unprecedented growth, and the U.S. is more than an interested spectator**



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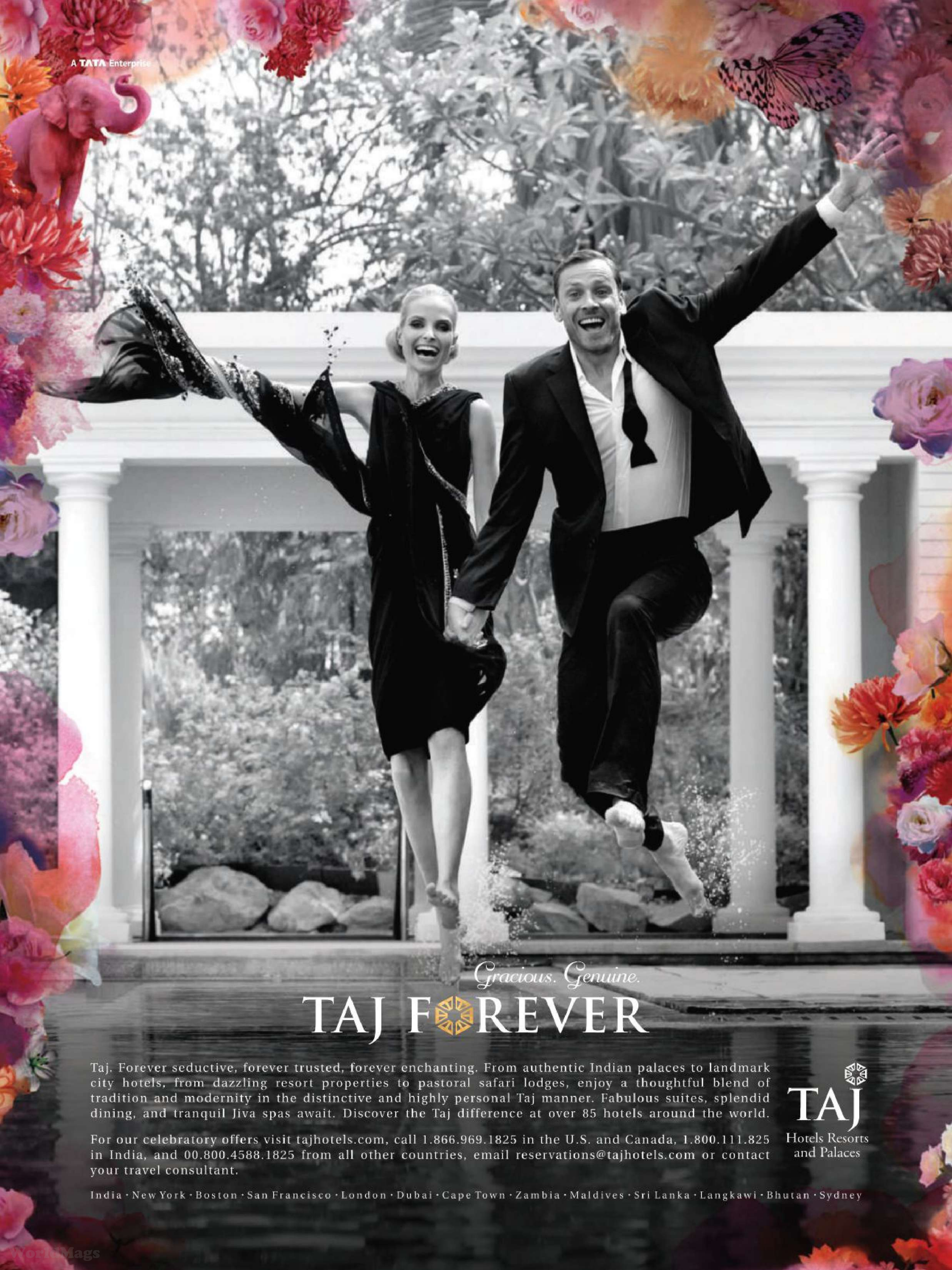
**As the 21st century began,** India walked the dividing line between modernized and underdeveloped. The century won't end with a similarly ambiguous perception of India; it's even possible that the present decade won't end that way. In his speech last fall to the Indian Parliament, President Obama saw fit to declare: "In Asia and around the world, India is not simply emerging, India has emerged."

Earlier in that address, the President drew loud applause by advocating India's ascent to the ultra-exclusive perch of permanent membership on the United Nations Security Council. Ratification of this endorsement has proved elusive. Still, it adds credence to U.S. assertions of India's new place among the elite.

Pursuing diplomacy and trade with a rapidly modernizing India, the U.S. could act the role of patronizing superpower, but by its policy and rhetoric Washington has veered from such typecasting. Geopolitics and global ecology are too fragile and volatile for American paternalism toward a valued Asian ally that is the world's largest democracy.

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There's something familiar in the acclaim offered to India by Obama (and his Oval Office predecessors George W. Bush and Bill Clinton). Their words echo tributes paid by previous Western thinkers. Ralph Waldo Emerson praised India's early philosophers for having "pondered and thus disposed of the questions that exercise us [now]." His 19th-century contemporary H.D. Thoreau called the Sanskrit Vedas "the royal road for the attainment of the Great Knowledge." To American historian Will Durant, India's tradition of wisdom was "the mother of [Western] philosophy" and its sprawling system of village communities the world's model "of self-government and democracy."

Those thinkers, were they still around, would recognize India as the epicenter of U.S. strategy in an unstable part of the world. Ron Somers, president of the U.S.–India Business Council (USIBC), states plainly that "India lives in a very rough neighborhood." The great unknown of Chinese long-term intentions continues to weigh on nearby India (and on America as well, China being its primary global rival). Even well-informed Westerners, according to Somers, don't realize that China invaded the disputed Indian region of Aksai Chin with a force of 20,000 as recently as 1962 "and still has troops on the ground inside the Indian border." In neighboring Pakistan, nuclear materials and technology that are a source of Indian concern were supplied by China, Somers points out, and some of that nuclear technology has found its way to Libya, North Korea and Iran. The nearby war zone in Afghanistan and general turbulence of the Middle East provide additional basis for a strong U.S.–India alliance.




**"India's progress in just two decades is one of the most stunning achievements in human history." — President Obama**

Promoting trade, investment and partnership between the two countries has been USIBC's mission since 1975, recognizing that strategic goals must rest on a foundation of robust commercial engagement. A host of factors make the work of expanding commercial ties particularly gratifying nowadays. Political bonds are strong with no sign of interruption, and they are underpinned by important shared beliefs in non-aggression, individual freedoms and the importance of higher learning. Along with these commonalities, however, come certain differences. India's role as a "late industrializer"—whereby a vast number of citizens still remain unsupplied with electricity—ranks the nation 145th worldwide in per-capita carbon emissions, compared to the U.S. at No. 10. Even with its comparatively good national emissions ranking, India has resisted U.S. urgings to support international treaties with binding caps on carbon emissions.

A recent policy brief by the Carnegie Endowment for International Peace offers important guidance to U.S. investors and marketers who are wondering whether sustainability issues will put the two governments at odds or draw them together. The brief points out that the government of Prime Minister Manmohan Singh, despite resisting the caps, "has begun to unilaterally implement an immense national agenda" for sustainable energy. These measures range from "large-scale reforestation to improving energy efficiency, to increased investment in renewable and non-fossil energy, to the planning of domestic carbon-trading programs."

In the closely watched area of defense spending, a planned outlay of nearly $11 billion for multi-role combat aircraft represents a landmark opportunity for several American manufacturers. Companies like Boeing, Lockheed, Honeywell and Raytheon have been constrained by India's decision to limit foreign direct investment in military defense to 26 percent of equity, but there is more at stake than just the pure dollar value to the U.S. economy that would flow from a







## INDIA: FACTS AT A GLANCE

**POPULATION**
1.21 billion. World's second-most populous nation, largest democracy

**GEOGRAPHIC SIZE**
1.27 million sq. mi. Seventh-largest country, about one-third the size of the U.S.

**POPULATION DENSITY**
15% of global population, on 2.4% of global land area



**POPULATION SPREAD**
70% live in 550,000-plus villages, 30% in cities

**MEDIAN AGE**
25, one of the youngest among large economies

**WORKFORCE**
467 million: 52% in agriculture, 14% industry/commerce, 34% services/government

**GDP BY SECTOR**
Services and transportation, 54.9%; industry, 28.2%; agriculture, 17%



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*The wharf at DP World Ltd.'s Nhava Sheva port in Navi Mumbai. It's the first Indian port capable of handling the world's largest container ships.*

ADEEL HALIM/BLOOMBERG



hefty share of $11 billion in contracts. Given the role of technology in India's present and future, any international collaboration in the tech arena builds both trust and further partnership opportunities.

In the view of Somers, India must also create openings for foreign companies in its financial services market, a move that would help drive economic maturation and establish a conduit for investment in India's infrastructure sector, while providing opportunity for American banks and insurance companies. "India has to open up the insurance sector," says Somers. "Such an opening would help create a long-term debt market. Long-term debt is the missing ingredient needed to fund India's plans for a vast outlay in infrastructure development—requiring $4.5 trillion by India over the next 10 years. That requires legislation and at least some shift in attitudes."

Having grown its GDP by 8 percent in 2009–10, and on track for GDP growth of 8.6 percent in 2010–11, India and its 1.2 billion people occupy a historically novel position. Building out its infrastructure and expanding human services to its vast rural territories, India needs technology to mitigate industrialization's environmental impact as much as it needs the technology to industrialize. Demographics pose a challenge, as so many live in rural poverty, but, overall, India's statistics hold out more promise than burden. Its inhabitants have a median age of just 25; 54 percent of the population is under 25, and 70 percent is under 35. G. Ravindran (Ravi), a people-business leader, is the CEO of SHRM India, the world's second-largest presence of the U.S.–based Society for Human Resource Management (the world's largest such association). His biggest long-term task is to leverage the "population dividend" that these statistics represent by collaborating with corporations (including multinationals), academic institutes, industry associations and local government administrators.

"In India," says Ravi, "50-plus is considered old, and not just because our population skews toward 30 and under. It's the attitude and character of this 'neo-generation.' They are heavily exposed to technology from childhood, and heartily embrace a rapid rate of change. We never hear 'It can't be done.'"

When Ravi looks forward to 500 million of the neo-generation entering the workforce in the next 10 years, he doesn't understate the challenge of making them workforce-ready. The goal, he says, will be to ready employers to receive talent with new attitudes, possibly into roles that do not exist today. As the education sector opens, there will be emerging demands on teaching and training, both brick-and-mortar and online. "We have 3,000 colleges now, but we could use 35,000 institutions with a sharp focus on employability," says Ravi.

It is worth noting that India is hardly a new market for major U.S. firms building facilities and employing native workers. Citigroup has been in India for 108 years. Gillette's presence dates far enough back that most Indians are unaware it's an U.S. company. Nor are foreign giants merely setting up small satellite offices in India: Accenture, IBM and Cognizant view the country as a valued IT hub, and employ hundreds of thousands there.

In preparation for this next reality, SHRM India's corporate solutions team is closely working with various stakeholders to enhance their HR capabilities. An industry-to-institute interface will drive an "assurance of learning" initiative that will increase workforce readiness. The association's research of best practices used by large organizations such as Indian Railways, Life Insurance Corp. and Accenture, can be showcased, replicated and scaled-up within India and globally. Networking forums and knowledge center initiatives communicate and share these best (and next) practices with HR practitioners across the country.

For the midsized or smaller American company entering the Indian market as a supplier or a joint-venture partner, expectations regarding the turning of bureaucratic wheels must be managed. Dr. Sada Joshi, founder and CEO of Tulsa, Okla.–based Joshi Technologies International (JTI), says Indian officials have been doing a better job in this regard. Recently working in the western Indian state of Gujarat, JTI took on a drilling project for which the environmental permits and other clearances were granted expeditiously. "Government has become more results-oriented," says Joshi. "I find there is more flexibility among bureaucrats in making decisions without unnecessary delays."

Educated in his native India, Joshi pursued a Ph.D. at Iowa State and found his way into the Oklahoma oil patch. JTI serves North America, Colombia, Ecuador and India. Oil and gas production, Joshi's mainstay, is one of many industrial-services and manufacturing categories where he sees opportunity for U.S. firms. "I talk to businesspeople from America and encourage them to expand into India," says Joshi, whose company is a leader in special petroleum extraction techniques. "Some of them have

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**"There is an Indian-ness in the way our young people are adopting modern things. India will modernize, but always be an exotic place." — Ajoy Misra, Taj Hotels**

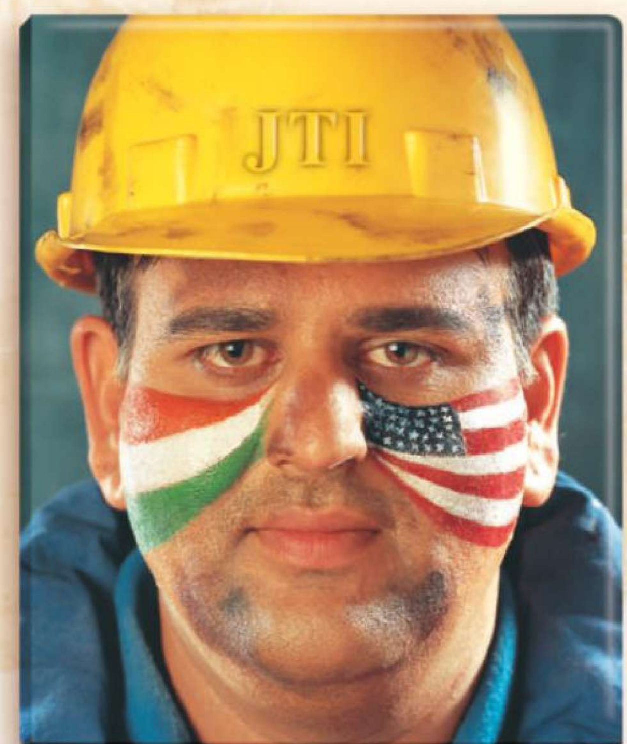
gone over and were successful in securing the business." Over the last 20 years, Joshi has observed a strengthening of the bond between India and the U.S. "Both are strong democracies," he says, "with the same need to be vigilant against terrorism and a shared belief that technology is vital to solving problems and helping society."

Rapid expansion of an economy across a gamut of industries naturally boosts the metrics of foreign visitation: According to the World Travel and Tourism Council, India business tourism will contribute over $14.2 billion to the economy in 2011, representing a 7.8 percent increase over 2010. Final figures for India's 2010–11 GDP growth in the hotel, transport and communications categories are expected to show year-on-year growth of 11 percent. When foreign businesspeople make trips to India, a large percentage of them patronize the Taj Hotels group—a pillar of the hospitality industry in a nation whose governmental agencies haven't yet opted for public-private ventures to build needed convention centers.

"India is taking steps to further accommodate very large conventions by constructing the necessary centers," says Ajoy Misra, the company's senior vice president of sales and marketing. Meanwhile, the private hoteliers fill the need. "Taj Hotels plays a significant role as either sole host or part of a network of host hotels handling events like the World Economic Forum conference," Misra says.

Out-of-country travel statistics for India's growing middle class are on a long upward trajectory, which many say has made the country less insular and more attuned to the Western pace of business operations. Misra sees his countrymen in the rising middle class turning their sights outward. "Indians traveled abroad at increased rates even during these two-plus years of recession," says Misra. "We have a new middle-class traveler who is getting out to see the world. These travelers start out on shorter trips, often on a tour package, but then graduate to farther-off destinations and begin to do their own trip planning."

Executives who see opportunity in the remaking of India naturally welcome modernization. Yet seldom is a Westerner's business trip to India not mixed with the pleasures of Indian culture, cuisine and character. Will swift modernization dilute these qualities? "I would answer in part by telling you about the young generation who will build India's future," say Misra. "There is an Indian-ness in the way they adopt modern things. When you come here in the future, your five senses will be stimulated as a traveler's always have. India will modernize, but she will always be an exotic place." ●




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A semi-official behavioral analysis page 78



Power Lunching & Craft Beer & Goldman

# Etc.

Plumbing the depths of royal wedding insanity page 82






SLOT MACHINE: TONY CORDOZA/ALAMY; JACKSON: BARRY GOSSAGE/GETTY IMAGES; PONDEXTER: SCOTT CUNNINGHAM/GETTY IMAGES

# Betting Below the Rim

A small group of professional gamblers have turned their attention to the WNBA. And they're making a killing. *By Eric Spitznagel*



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# Etc. WNBA Gambling

Tim York's WNBA fetish makes his wife jealous. "She sometimes asks me, 'What do you see in women playing basketball?'" says the 31-year-old Houstonian. "Sure, some of the girls are nice to look at while they're playing. But that's *not* why I do it." Unlike creepy voyeurs, or purists who like watching a below-the-rim game played at a reduced tempo, York's interest in women's basketball is purely financial. "I tell her all the time, 'There's money to be made in this sport.'"

A professional gambler and owner of the Las Vegas-based handicapping company Sharp Group, York is at the forefront of the women's sports-betting movement. As Women's National Basketball Assn. franchises prepare to start training camp this month, York's in the middle of his annual analysis of all the league's teams and players. In the three years that he's been betting on the WNBA, his preparation has paid off: York says he has made a considerable portion of his estimated $100,000 annual earnings from the league. It's quite a feat given that the WNBA comprises only 12 teams that play a 34-game schedule over a four-month regular season. When it comes to women's basketball, York says, "I consider myself to be one of the best in the business."

There isn't a whole lot of competition. While $2.76 billion was legally wagered in Nevada's sports books during 2010, according to the Nevada Gaming Control Board, there's no record of how much was bet on the WNBA. Scott Ghertner, director of sports and promotions for MGM Mirage in Las Vegas, figures it was "perhaps a couple of percentage points at the most." And that's exactly how professional gamblers like it. "It leaves an opportunity," says York, "for guys that do this for a living to step in and see things that the oddsmakers sometimes don't."

Jay Rood, the sports book director for MGM Mirage, concedes that bookmakers have created an opening for WNBA gambling pioneers to exploit. Bookmakers "probably don't pay as close attention to the WNBA as we do with other things," he says. That's because most casual gamblers aren't interested in women's sports—even the ones where the players are almost naked and tackling each other. "We booked the Lingerie Bowl this year," Rood says, referring to the Amazonian pay-per-view football contest that aired during halftime of Super Bowl XLV. "But it was very, very lightly wagered into." In Rood's experience, women's sports is the domain of professionals or, as he calls them, "the sharpest players." If you're betting on the WNBA, you probably mean business, Rood says. "It's one of the hardest sports to profit at."

That's because comprehensive WNBA statistics aren't as readily available as in other pro sports leagues. "If the third-leading scorer for the New York Liberty is out, not many people are going to be able to estimate her value," says Edward Golden, a handicapper for the Internet betting service Right Angle Sports. He says he has had a 59 percent winning ratio on more than 300 WNBA bets during the past three years. To maintain this success for his seven-plus weekly WNBA plays, Golden tries to "gain as much intimate knowledge as possible on every WNBA team, player, and coach in the league." He exhaustively compiles the data all by himself.

**WNBA games offer gamblers a chance to "see things that the oddsmakers sometimes don't"**

York expects big things—and to make a lot of money—from Cappie Pondexter and the New York Liberty



Such devotion is a trademark of WNBA bettors. Anthony Nassor, founder of Las Vegas-based Blueprint Sports Monitor, a handicapping and wagering management service, says more than 30 percent of his business comes from the league. In preparation for each WNBA game, Nassor evaluates dozens of variables, including how many of each team's players competed professionally overseas during the off-season, each team's recent travel schedule, and how much energy—based on the opponents' style—the players exerted in previous games. Nassor also bases his wagers on defensive numbers rather than just offensive output. He computes a "cumulative defensive" statistic that he converts into a "hypothetical total"—and then keeps the information to himself. He also has a habit of betting against deceptively hot teams until they start losing and wagering on home teams returning from winless road trips. If that doesn't work, he monitors players' Twitter feeds, looking for even the slightest hints about injuries, emotions, or other factors that might help him decide which side of the spread he wants to bet on. Wagering on WNBA games, he says, is just like playing the stock market. "You do your indexing and research and analyze your budget," he says, "and try to buy in when a good stock is low."

This philosophy has helped Nassor expand his business through satellite offices in Bakersfield, Calif., and Hanover, Germany. Despite the skepticism of his peers, he remains a proud trailblazer. "Most of the big betting guys that I know, their main worry is that it's easier for a woman to get bribed and throw a game," Nassor says. "That's part of the underworld's problem with betting on it. But I think the WNBA plays a pretty straight-up game."

Regardless of any potential loss of revenue from organized crime or other wary gamblers, the women's sports-betting movement has come a long way. Back in the 1990s, a bookmaker named Robert Walker, the Betty Friedan of gambling odds, had a vision. While running sport books from the MGM Mirage to the Stardust, Walker was one of the first oddsmakers to treat women's sports betting equally. Although his friends and colleagues told him he was crazy, he booked everything from the NCAA Women's basketball tournament to the WNBA Finals. Walker quickly learned the hard way that such betting was for professionals only. "It got kind of personal," he remembers. "I would have guys come in and want to bet $5,000 on a game. If you take $5,000 on a women's basketball game, [the sports book

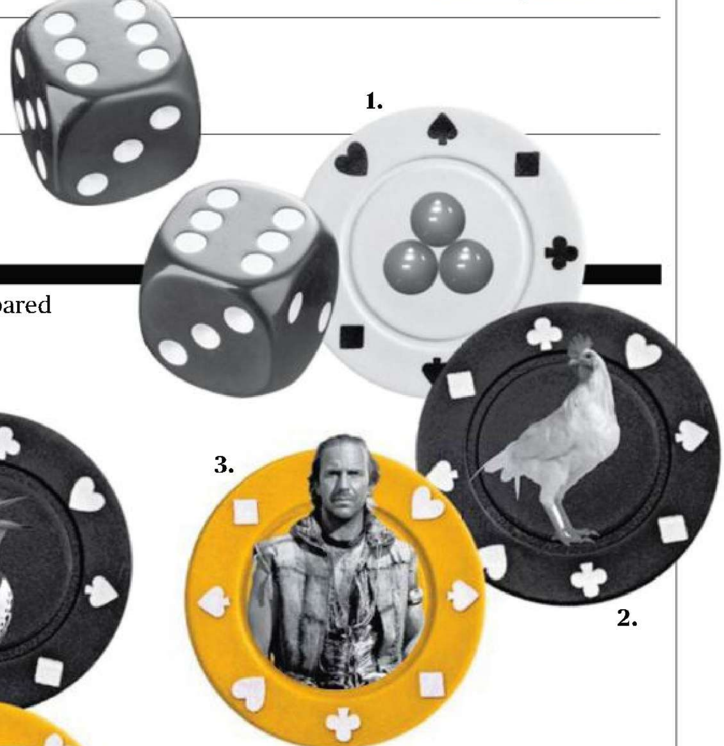
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# What Are the Chances?

Wagering on the WNBA may seem unusual, but it's nothing compared with betting on cockroach races—or the antics of Randy Jackson







**1. Snooker**

In the U.K., betting on snooker—a game similar to pool, but with fewer pockets and no numbers on the balls—is a popular pastime. Gamblers wager on professional players' odds of winning a match.

**2. Chicken Drop**

Belize is the world capital of Chicken Drop gambling—a game of risk that's exactly what it sounds like. Gamblers predict the area on a field where a chicken might drop feces and then wait and watch. Now they've thought of everything...

**3. Hollywood**

Founded in 1996, the Hollywood Stock Exchange website takes wagers on the fates of actors and movies. Alas, if only you could have shorted *Waterworld*.

**4. Finching**

This Flemish sport is enjoying a popularity resurgence akin to its 17th century heyday. Birds vie to sustain a tweet for the longest time as gamblers try to pick the winner.

**5. Amazon Rankings**

The website Smarkets gives gamblers a chance to wager on the popularity of Amazon.com's more obscure products—such as Deerbusters' 32-oz Wolf Urine ($31.95)—based on their Amazon rankings.

**6. Darts**

It's a real sport, with a world championship played each year in England. If you'd doubled down on Phil Taylor 20 years ago—he's won 15 world titles—you'd be reading this in St. Bart's.

**7. *American Idol***

The sports book Bodog.com offers categories for sophisticates. Example: "Will Casey Abrams and Randy Jackson both appear onstage together playing the bass at any point during the season?"

**8. Cockroach Racing**

This contest—a Russian tradition—doesn't just offer betting positions on which roach will emerge the victor. Gamblers also lay down money to guess the length and weight of the diminutive athletes.

is] against that guy. We didn't have people betting $50 on the other side of it. We didn't have enough money to offset it."

It became a contest between Walker and the finest minds in the sports book trade. And when he lost, he lost big. "We definitely struggled in the beginning," he says. "It eventually got better, but it was always a crapshoot." Without much data or Internet research to base his odds on, he says he sometimes felt like "we were throwing darts and hoping for the best"—a strategy that didn't play all that well with his bosses.

These days, Walker lives in a small town on the Washington-Idaho border, his departure from the sports-booking business having been hastened, in part, by his youthful fervor for women's sports. "In 1996, I predicted that in 10 or 15 years, women's basketball would be as popular with gamblers as the men's," he says. "I also said that sports gambling would be legal in every state except Utah. I couldn't have been more wrong." Still, Walker maintains a passion for the women's game and is looking forward to watching the 2011 Seattle Storm and its star player, Lauren Jackson. "If you watch Jackson play and you don't come away as a fan," he says, "you're insane!" He admits, though, that "it's not the same when you don't have money on it."

**According to one bookmaker, the WNBA is "not the same when you don't have money on it"**

York would agree. Last June, as the 2-8 Minnesota Lynx prepared to play the 2-7 Los Angeles Sparks, the Houston gambler got a lucky feeling. With both teams slumping, oddsmakers placed the line for total points scored—known as an "over/under" line—at 161.5. "*Everyone* was running from the 'over,'" says York. "Except me." Nine months later, he still remembers the thrill he felt as the final whistle blew on the Sparks's 88-84 win—and York pocketed a figure in the "high" hundreds. The game received almost zero media attention, but it lives on in his memory as a reminder of how the WNBA can lead to some sweet, fast money. B



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# Lunch Theater

## Your power lunch etiquette is talking—and the room is listening.

*By Tim Murphy*

Who knows what *Gossip Girl* star Blake Lively and Israeli venture capitalist Vivi Nevo were discussing over a recent lunch at Michael's, the preferred noontime canteen of New York's media, real estate, and political elite. But one thing is certain: If they were at Michael's, they *wanted* people to know they were in touch. Alas, the point of going out to lunch "is to see and be seen," says former *New York Post* gossip columnist Liz Smith, who says her recent sightings at the Four Seasons restaurant have included the trio of David Rockefeller, Bill Clinton, and Blackstone Group co-founder Pete Peterson. "It's all about who's who in the room," says Sam Lipp, who manages Manhattan's Union Square Café. "Tables are even passed down to colleagues when people pass away."

Ordinary mealtime behavior can take on layers of meaning when viewed under a high-stakes microscope. *Bloomberg Businessweek* recently spied on more than 150 power lunchers at three of New York's swankiest venues—Michael's and the Four Seasons in Midtown, and Nello on the Upper East Side. Here we've categorized their behavior—more than one can apply per diner—according to a panel of experts, including Smith; Lipp; Patti Wood, author of the forthcoming *Snap! Making the Most of First Impressions*; David Givens, author of *Your Body at Work*; and Loews Hotels Chairman and Chief Executive Jonathan Tisch, an inveterate luncher who can be spotted nibbling Cobb salad at many of the city's most esteemed hasheries. ⓑ



**32%** *(of people observed)*

### BlackBerry Absorbers

People who thumb their way through lunch "are saying, 'I want to be seen with this person, but I'm so important I have other things to tend to,'" says Wood. Tisch: "It's extremely rude—unless you're checking to see if you won the Lotto."

**38%**

### Lunch Boozers

A risky move. "Have as many glasses as your boss," says Givens, unless your boss is Charlie Sheen. Tisch adds, "This is appropriate if you're on vacation." Smith agrees: "In the '60s we'd all have two martinis at lunch. But nobody really drinks at lunch anymore."



**19%**

### Nervous Phone Gazers

Continuously glancing at a mobile device on the table is "a comfort cue, like a security blanket," says Wood. Lipp believes it's a way for wary workers to play hooky: "I'll have diners drinking wine who, if someone calls, say they're out at a meeting."

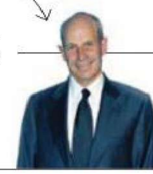
**34%**

### Overeager Proprietor Acknowledger

Being visited by the owner "makes us all feel good and wanted," says Tisch. According to Wood: "The tribal leader is saying, 'You're an honored member of my tribe.'" Smith: "They always interrupt when somebody's telling a fabulous anecdote."

**Other Disturbing, Less Frequent Power-Lunching Behaviors** ▶ BIG, DARK SUNGLASSES-INDOORS WEARER / ▶ EXTREMELY LOUD GUY MAKING BAD JOKES IN AN OTHERWISE SUBDUED SPACE / **Givens:** "He may have Nonverbal Learning Disorder (NLD)—

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Loews Hotels chief and power lunch aficionado Jonathan Tisch

**27%**

## Power Table-Hoppers

Stopping at tables to chat or double-air-kiss is "a power move," says Lipp. Givens: "It's a measure of your connectedness." Tisch notes that working the tables "can be an art form if done discreetly." Smith: "Keep it short. Don't join the table."

**12%**

## Table-Hopper Deniers

Curtly saying "buh-bye" and turning one's back to table hoppers is "catty," says Wood. Givens adds that the person who terminates the conversation "is higher-status." "I frequently wish people would go away," says Smith, "but I still wouldn't. It's rude."

**52%**

## Food Pusher-Arounders

"The more junior person tends not to finish," says Lipp of people who leave half their lunch uneaten. "It shows restraint," says Wood. Givens agrees: "You're performing." Tisch is sympathetic: "When you eat out 21 times a week, this is mandatory."



**47%**

## Bread Decliners

Not touching the breadbasket? It makes "the other person seem bad," says Wood. Givens notes that it conveys "hyper-concern with your appearance." Smith says: "I don't go to these places for the food anyway."

**3%**

## Coat Check Refusers

Keeping your fur hat, coat, or vest on during a meal is "old-style showing off," Wood says. Lipp thinks it means "I don't trust your coat check" to keep my fur clean. It's a power move, Smith notes: "It says you're not afraid of spilling food on your furs."

**2%**

## Solo iPad Readers

Lunching with your tablet is "the modern-day version of dining alone with the newspaper," says Tisch. It sends a message, Givens notes, "that you eat in these places so much that they're like your home." No, Smith says—it's an "act of desperation."

**Givens:** "You want to project an air of mystery. And you can scan the room without giving yourself away. They are your protection."

trouble picking up cues that people around him don't like a loud voice." ▶ **BLUETOOTH TALKER-EATER** / **Smith:** "That's rude and insane."



ILLUSTRATION BY CHI BIRMINGHAM; TISH: ANDREW H. WALKER/GETTY IMAGES

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In his day job as a TV executive, Andy Cohen masterminds catfights in his Manhattan office




# The New Queen of Late Night

## The reality TV guru has moved in front of the camera—and he's beating Conan. *By Ronald Grover*

Sitting in his 46th-floor office at 30 Rock, Andy Cohen—producer, reality TV *auteur*, camp icon—is previewing his latest creation, the fourth season of *The Real Housewives of New York City*. "The reactions are off!" Cohen complains over the phone to one of his producers. The series, which follows a gaggle of nouveau riche damsels as they bicker, go shopping, and talk about their ultrafabulous lives, has become a ratings sensation for Bravo. And though the new season is scheduled to debut in weeks, Cohen knows more work is needed. "It's very ... talky," he complains of one protracted party scene. After hearing a catty barb unleashed moments later by one character, Cohen homes in on the problem: Cast member and countess-by-marriage Luann de Lesseps, he says, "has to be more offended!" Cohen swiftly orders a close-up of her horrified visage and—crisis averted—moves to the next scene.

**"Some people need a vacation or more money. Andy needs to perform," says Lauren Zalaznick**

As Bravo executive vice-president, Cohen has made his Manhattan office a mini-shrine to his burgeoning reality fiefdom. Scattered throughout are framed posters, pictures, and tchotchkes immortalizing a number of his greatest hits—including *The Real Housewives of Orange County*, *Top Chef*, and *Flipping Out*. Outside his door is a picture of Cohen interviewing Jerry Seinfeld on his talk show, *Watch What Happens Live*, which averages 1.6 million viewers and regularly beats *Conan*. Among the cubicles is a faux Warhol painting of *The Real Housewives of Atlanta* cast. In February, the last episode of the reality show's third season attracted 4.4 million viewers—



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Three Beverly Hills housewives engage in friendly squabble



Cohen's late-night talk show, *Watch What Happens Live*, has featured Bravo cast members, real celebrities, and Lance Bass







A Warholesque depiction of a *Housewives* cast in Bravo's offices (left); Cohen keeps a supply of his own Maker's Mark whiskey (right)

over a million more than the most recent *Mad Men* finale. This month the New York branch returns.

Almost pathologically uninhibited, the openly gay Cohen, 42, is a natural reality TV impresario. As a kid in St. Louis, he fell in love with *All My Children* and *Charlie's Angels*. After graduating from Boston University, he moved to New York and spent the first 10 years of his career as a producer for CBS News before a stint at the now-defunct cable channel Trio. In 2005, Cohen landed a producer's job at Bravo just as the network was transforming itself from the province of arts programming and *West Wing* reruns to an original content hub. Spurred by niche hits such as *Queer Eye for the Straight Guy*, Bravo was making a foray into reality plots that transcended half-naked people trapped on desert islands. Under Lauren Zalaznick, now NBC Universal's chair of Entertainment & Digital Networks and Integrated Media, the network pursued shows that

**Bravo will generate $300 million this year, up from $110 million in 2005**

would appeal to what it called "affluencers," a term Cohen helped define as upscale women with time—and a lot of disposable income—on their hands.

Starting in 2005, he oversaw reality fare curated specifically for the botoxerati. During his first year, his predecessor, Frances Berwick, was pitched a scripted *Curb Your Enthusiasm*-style comedy focusing on wealthy Orange County women. Instead, Berwick and Cohen recast the idea as a reality show, and in 2006, Bravo launched *The Real Housewives of Orange County*. The franchise, now in its sixth season, has spawned spinoffs in Miami, New York, New Jersey, Washington D.C., Beverly Hills, and Atlanta. "*Housewives* is a reality *Peyton Place*," explains Cohen, noting that, just like in the Lana Turner movie, "the women are hot moms with big boobs who have problems communicating with their teenage kids."

The trophy wife mind-trick is working. In addition to branded books and clothing, the network is delving into other nouveau riche enclaves. It's licensed the format for *The Real Housewives of Athens* and is working on deals for similar shows in Canada, India, Israel, and Turkey. This year Bravo will generate $300.6 million in cash flow for parent company NBC Universal, up from $109.9 million in 2005, according to SNL Kagan cable analyst Derek Baine. In the six years since Cohen joined the network, ratings among 18- to 49-year old women have doubled. Last year, the network claims, it added 150 new advertisers, plus 50 online. "He has a great sense of what people want to see," says Jeff Lewis, who remodels houses and terrorizes his assistants on Bravo's real estate show *Flipping Out*. Cohen decided to cast Lewis as the show's lead character even though he had a supporting role in the pilot. The series, which recently wrapped its fourth season, is also launching a spinoff, *Interior Therapy with Jeff Lewis*.

To boost ratings and increase exposure for its programs, Bravo gave Cohen his own twice-per-week talk show in 2009. *Watch What Happens Live* is essentially a forum that allows Cohen to be himself as he gossips with cast members and fans—often while nursing a drink. "Some people need a vacation or more money," says Zalaznick. "Andy needs to perform." The performances can get cringeworthy, too. On one recent episode, Cohen held a belated farewell party for a *Housewives* character's breast implants after she had them replaced. "We're always wondering if he's going to go too far, and sometimes he comes close," says Berwick, now Bravo president. "But it's hard to argue with his success."

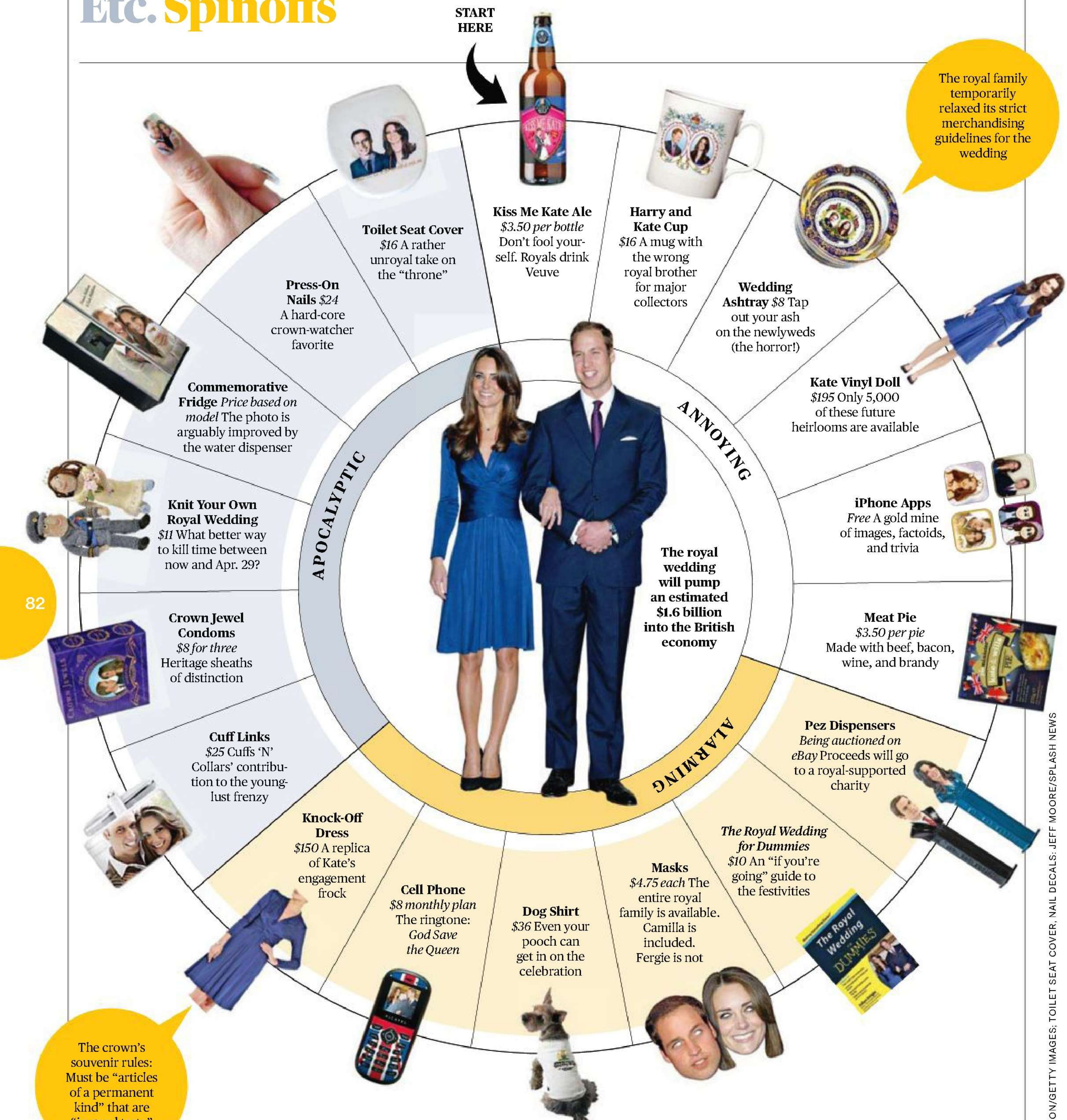
Yet Cohen's success—whether as a host or producer—is rooted in his ability to go too far. This year he will oversee 346 hours, or five full nights, of original programming—a leap from 2008, when Bravo scheduled only three nights. It might not be possible if the person producing the shows didn't happen to be their biggest fan. "Every woman needs a gay best friend to hang out with," says Cohen. "I play that role." B

COHEN: PHOTOGRAPHS BY MARTHA CAMARILLO FOR BLOOMBERG BUSINESSWEEK (4)



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# Etc. Spinoffs






# Bride Extensions

Wills and Kate's April nuptials are setting a particularly dubious entrepreneurial precedent. *By Roger Bennett*

WILL AND KATE: CHRIS JACKSON/GETTY IMAGES; TOILET SEAT COVER, NAIL DECALS: JEFF MOORE/SPLASH NEWS

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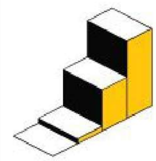
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# Etc. One True Thing

# The Craft Beer

In 1980, 26,470 barrels of craft beer were sold. Last year, that figure was nearly 10 million




## A brew that comes in a serious bottle, has flavors as complex as wine, and packs a punch

**The Want:** A seasonal wine alternative to impress clients or co-workers. The beer should be obscure but accessible; it should also have a cool label, but it *cannot* be cutesy.

**The Get:** Brewery Ommegang Abbey Ale ($8.99, 750 ml; ommegang.com). This Belgian-style *dubbel*, like those brewed by Trappist monks, is crafted at Brewery Ommegang in Cooperstown, N.Y. The mahogany-colored ale has a frothy head, features an intricate blend of flavors–cherries, raisins, and brown sugar–and pairs well with meat, rich cheeses, and dessert. The alcohol content: 8.5 percent, so get the guest beds ready. B —*Duane Stanford*

i

**PROHIBITION LITE**

*Home brewing takes beer snobbery to a new level*

For craft brew freaks, there are all-in-one brewing kits such as this option from Australia's Coopers Brewery. The process is not glamorous, but it's pretty easy. First, create a liquid "wort" by adding malt concentrates and sugar to hot water. Then pour the wort into the fermenter and add yeast. Seal and wait four to seven days. Pour the beer into bottles and add some sugar. Store for 14 days, then call your friends and book the band. *$99.99 at makebeer.net*







Brewery Ommegang, in Cooperstown, N.Y., is a regional craft brewery with an annual production of 22,000 barrels

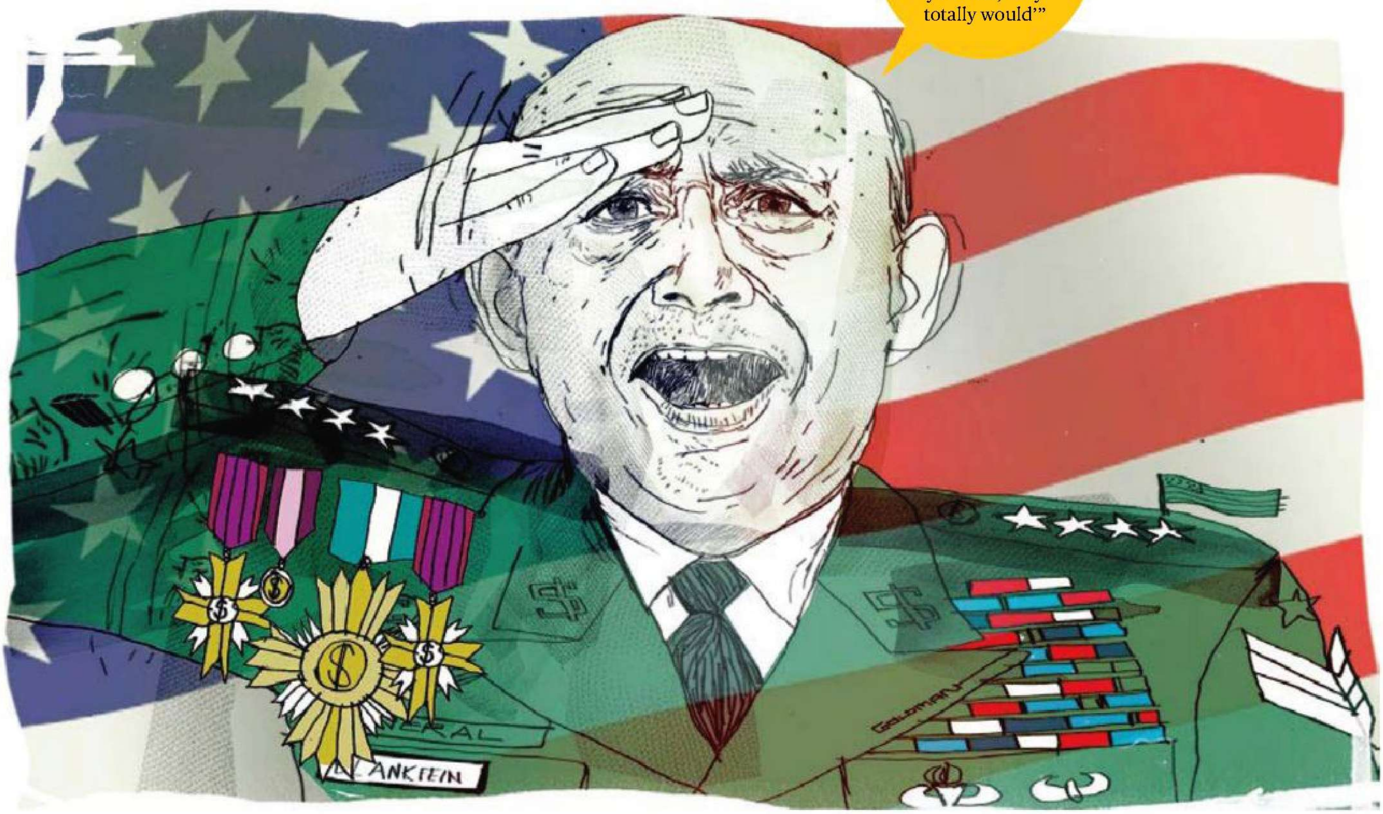
Ommegang Abbey Ale is available in 12 oz four-packs and in corked 750 ml bottles like this one

ALE: PHOTOGRAPH BY JAMIE CHUNG FOR BLOOMBERG BUSINESSWEEK; DATA: BREWERS ASSN.



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One former Goldman banker tells Cohan, "'if they could eat your lunch and screw you over, they totally would'"

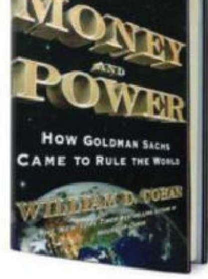




# The Goldman Doctrine

How does the investment bank make so much money? It's actually simple. *By Ian McGugan*

**Money and Power: How Goldman Sachs Came to Rule the World**
*by William D. Cohan*
DOUBLEDAY
658 pp; $30.50




It's a bit scary when a 658-page history of an investment bank seems destined to be a runaway best-seller. Such is the wonder of Goldman Sachs. In 2009, William D. Cohan wrote one of the financial crisis oeuvre's most memorable tomes, *House of Cards*, about the swift collapse of Bear Stearns. With *Money and Power*, he's found his way to the other side of the spectrum. And on that end, there's no shortage of Goldman clients, rivals, and former employees willing to explain how greed and recklessness—the same qualities that doomed Bear's balance sheet—led Goldman to become too big, too powerful, and even too conflicted to fail. As one Goldman alum puts it, "I saw what they did to their customers. ... They'd steal from them, rape them, anything they could do." It worked like a charm.

Given Goldman's bare-knuckled attitude, Cohan depends on a wide range of unnamed sources. Judiciously relying on their insights, he has produced the frankest, most detailed, most human assessment of the bank to date. Yet the firm winds up looking in many ways like nothing more than a slightly brighter, slightly less foulmouthed version of Bear; it's just as greedy, just as arrogant, and just as prone to mistakes. Though Cohan acknowledges the firm's extraordinary ability to recruit and indoctrinate the best and brightest, what seems to truly set Goldman apart is its ability to be a half step quicker than its rivals in correcting itself.

After all, this is a firm that periodically eviscerates those who trust it most. In the 1920s, Goldman ran a Ponzi-like scheme involving investment trusts. In the 1970s, it peddled soon-to-be-worthless commercial paper for the soon-to-be-bust Penn Central Railroad. And, in 2007, the firm that prided itself on being "long-term greedy" sold gullible clients on the merits of mortgage-backed securities—

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**DOPPELGÄNGER ALERT!**

Lloyd Blankfein  ⟷  Wallace Shawn

while simultaneously shorting some of those same debt obligations. The firm has succeeded, in part, by ignoring these nastier aspects of its past. In fact, Goldman never misses an opportunity to celebrate the holier-than-thou principles laid down by former senior partner John Whitehead. Rule No. 1: Our client's interests always come first.

*Money and Power* suggests the bank does possess a few special powers, starting with its remarkable ability to convince some of the world's smartest young people that touting stocks, sniffing out arbitrage opportunities, and shaking down corporate clients amount to a noble calling. One illuminating anecdote in *Money and Power* concerns Robert Rubin, the former Goldman head who would go on to become Treasury Secretary under Bill Clinton. During his third year at the firm, back in 1969, Rubin's career path may have hit a rough patch. Sandy Lewis, who at the time ran the arbitrage department for a rival bank, tells Cohan that Rubin approached him regarding a job opportunity. Lewis explains that Rubin had grown disgusted with the Goldman way. "It's a dishonest mess," Lewis recalls Rubin saying to him, "that's making honest people dishonest."

Whether or not Rubin was seriously looking outside the firm, he stuck around and soon led Goldman into areas that had previously been considered off-limits—such as asset management—for fear of potential conflicts with clients. A former top partner—unnamed, but in a position to judge the firm's swelling appetite for profits at any cost—says Rubin encouraged a culture of undisciplined risk taking. "A lot of these practices were set up when [Rubin] was there," he tells Cohan. "The lack of a risk committee, trusting individual partners ... and letting traders become too important and being afraid to confront them if they've been big moneymakers. All that sort of stuff built up."

As profits swelled under Hank Paulson, and then Lloyd Blankfein, Goldman was edging further into trading money for its own account—and pushing the boundaries of what had previously been considered an acceptable conflict of interest. Simultaneously, the bank became more obsessive about managing the darker side of its sprawling empire. A reputational risk department, staffed by former CIA operatives and private investigators, vetted new hires and policed employees who got out of line. While the department may have missed clues about "Fabulous" Fabrice Tourre, the firm relied on its level of diligence, and it became part of the culture. "Not that they would come to my house and beat me up or something or kill my children," a former Goldman trader says. "But certainly they would drag you through court or do something to screw up your life. If you did anything to hurt that firm in any way, all bets were off."

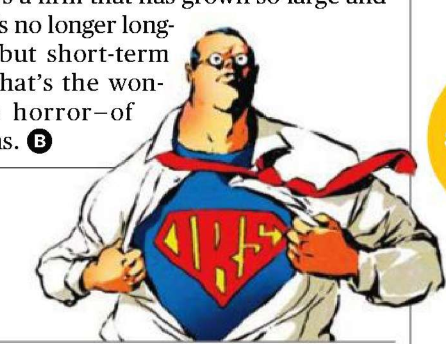
**"If you did anything to hurt that firm," says a former Goldman trader, "all bets were off"**

Meanwhile, the bank put its talent to use finding ingenious ways to divvy up risk and sell it off to unsuspecting clients. It helped develop magic tricks such as synthetic collateralized debt obligations that allowed investors to bet for or against the housing market without ever owning a single real mortgage. Most famously, Goldman created synthetic CDOs and allegedly allowed hedge fund guru John Paulson to bet against particularly rotten mortgage packages without telling the buyers on the other side of the deal.

Yet Goldman realized sooner than its Wall Street peers did that the nation's love affair with real estate was over. Cohan describes how the company nimbly dumped its mortgage-backed securities on its own clients. This created a big short position against the housing market, allowing it to reap enormous profits while the Bears of the world failed. Was this a sign of Goldman's superior intelligence, or simply its willingness to knife anybody for a dollar? Both, it seems. Cohan portrays a firm that has grown so large and hungry that it's no longer long-term greedy but short-term vicious. And that's the wonder—and the horror—of Goldman Sachs. B



# Heavy Breath and Taxes






**The Pale King**
*by David Foster Wallace*
LITTLE, BROWN
560 pp; $27.99

**On Apr. 15, IRS agents get to be the heroes. In addition to being tax day, the 15th marks the publication of *The Pale King*, David Foster Wallace's posthumous novel celebrating the lives of Internal Revenue Service workers. Could *The Pale King* do for 1980s IRS employees in Peoria what *Mad Men* did for 1960s copywriters in Manhattan?**

**Sadly, it won't. The problem is that Wallace defines heroism a little differently than television does. In the Knute Rockne-like speech that inspires one character to join "the Service," a professor says, "Enduring tedium over real time in a confined space is what real courage is." This isn't exactly the same as getting drunk and sleeping with your secretary, but Wallace's premise is that in this era of micro-attention spans, there's a great dividend in giving one's full attention to something—even obscure tax laws. And on Apr. 15, a bunch of ordinary heroes staring at page after page of returns will keep those words alive. Their only hope is that Jon Hamm plays them in the adaptation. —*Joel Stein***

OPPOSITE PAGE: ILLUSTRATION BY PATRICK MORGAN; THIS PAGE, ILLUSTRATION BY: CHRISTINA UNG; BLANKFEIN: ANDREW HARRER/BLOOMBERG; SHAWN: MICHAEL BUCKNER/GETTY IMAGES

**Bloomberg Businessweek** (USPS 080 900) April 11 – April 17, 2011 (ISSN 0007-7135) T Issue no. 4224. Published weekly, except for a double issue in August and one in December, by Bloomberg L.P. Periodicals postage paid at New York, N.Y., and at additional mailing offices. Executive, Editorial, Circulation, and Advertising Offices: Bloomberg Businessweek, 731 Lexington Avenue, New York, NY 10022. **Postmaster:** Send address changes to Bloomberg Businessweek, P.O. Box 8418, Red Oak, IA 51591-1418. Canada Post Publication Mail Agreement Number 41989020. Return undeliverable Canadian addresses to DHL Global Mail, 355 Admiral Blvd-Unit4, Mississauga, ON L5T 2N1. Email: bwkcustserv@cdsfulfillment.com. QST#1008327064. Registered for GST as Bloomberg L.P. GST #12829 9898 RT0001. Copyright 2011 Bloomberg L.P. All rights reserved. Title registered in the U.S. Patent Office. Single Copy Sales: Call 800-298-9867 or email: busweek@nrmsinc.com. Subscriber Services: Call 800-635-1200 or log onto our website: http://www.businessweek.com/custserv/manage.htm. Photocopy Permission: Where necessary, permission is granted by copyright owner for those registered with the Copyright Clearance Center (CCC), 222 Rosewood Drive, Danvers, MA 01923 or email the CCC at info@copyright.com. Custom Reprints: For customized bulk reprints of Bloomberg Businessweek articles, contact The YGS Group at 800-360-5549 or email: businessweekreprints@theYGSgroup.com PRINTED IN THE U.S.A.

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# Etc. Hard Choices

# Herbert Hainer

## "[Reebok] sales kept going down for three years. Financial analysts and investors were asking, 'Do you people really know what you're doing?'"

The Adidas chief on buying Reebok and sticking with his plan to go upscale despite the recession and investor grumbling





The U.S. was always a challenging market for us. When we took over Reebok in 2006, we saw it as a way to expand here. I felt we could position Reebok as a premium American fitness and training brand and use it to build our market share. I was confident in our plan for how we would make Reebok succeed.

But there were surprises. We had to do much more cleanup work than we thought. Reebok was over-distributed: We didn't want to be in places like Wal-Mart or Tesco anymore. About 30 percent of the revenue was at price levels of $39 and below. You earn neither image nor money with those prices.

There was also jealousy left and right. When you've been competitors for 20 years, it's hard to suddenly be friends. We wanted to give some leverage to Adidas, so we took over the NBA sponsorship from Reebok. That did not get us a lot of applause at Reebok, of course.

We started to invest in new products, but it takes 18 to 24 months to see those changes. Reebok lost market share, and sales kept going down for three years. Financial analysts and investors were asking, "Do you people really know what you're doing?"

Some people in the company began to question our plan. I spent a lot of time at Reebok, holding town halls and talking to people in the cafeteria. They wanted to see the light at the end of the tunnel. After we had at least cleaned up the market and were seeing an uptick, the financial crisis hit. I thought, "Bloody hell, not now!"

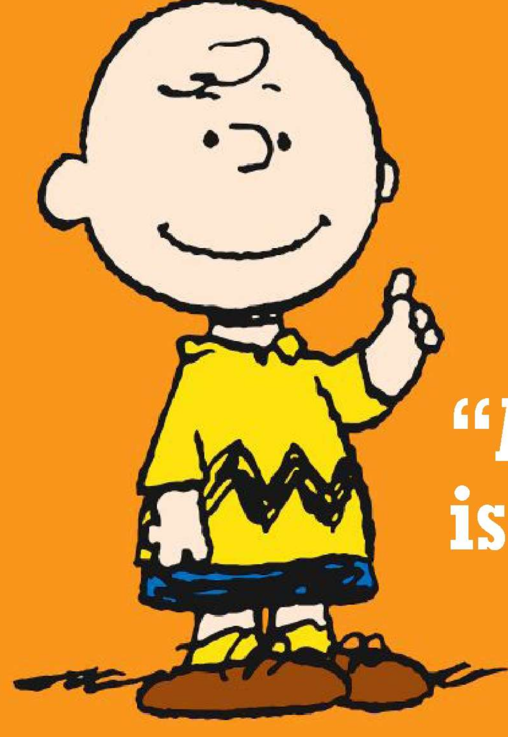
If I could do it again, I would have managed expectations better. We didn't give a time frame for how long this would take, and I didn't replace people fast enough. Still, Adidas and Reebok are both growing.

Right now, our biggest challenge is the rising costs of raw materials. We'll have to increase Reebok's prices, which will take trial and error. We have to protect our margin, but we also don't want to lose too much volume. We want to build on our success: The good thing now is that our brands are in demand. Ⓑ

*—As told to Diane Brady*

PHOTOGRAPH BY MIKE MCGREGOR FOR BLOOMBERG BUSINESSWEEK

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